Contract Number: 169-C-00-11-00102

Project: Sustainable Local Development Project in Serbia

Contractor: Chemonics Inc.

USAID COR: Mr. Sinisa Cadjo

Issuance Date: November, 2014

Document Title: Privatization in Serbia - Five Case Studies and Key Conclusions

Author: NALED

Language (if non-English):

Effects of Privatization on Local Governments' Fiscal Balance - Case Studies

PROJECT SUMMARY

As the case is in other transition countries, privatization in Serbia was a key element of structural reforms, and has had several key objectives – increased economic efficiency, improved fiscal position of the state and development of the national capital market. From the beginning of the 1990-ies, privatization in Serbia was carried out through several different models. However, today, almost 20 years after the process began, privatization in Serbia is not completed.

Despite relatively frequent changes of the applicable regulatory framework, which were meant to speed up the process and complete the unfinished privatization agenda, over the past years the privatization process seems to be in a stay, while the key problems, which were instrumental in such delays in the process – surplus workforce, unresolved ownership issues, over-indebtedness – remain unresolved. The companies that are still not privatized represent not only locked capital, but are also a permanent source of costs for the central budget and permanent loss for LG budgets.

The role of local self- governments (LGs) in the privatization process, unfortunately, is often overlooked. The privatization process in Serbia is managed centrally, and the LGs hence fail to recognize their role in the process. In addition, they are often not fully aware of the negative effects of the unsuccessful privatization to their budgets and the potential financial gains from a successful one. Consequently, they do not take an active role in this process.

NALED has developed this project aiming to identify the causes of unsuccessful privatizations and their effects to local economy and finance, to analyze best practice examples in peer companies and through a comparison of the two, assess the potential of the remaining privatization process. In addition, NALED wanted to outline the general economic and regulatory environment in which privatization was carried out and formulate recommendations for improving the regulatory framework aimed at efficient completion of this process in Serbia.
Through case studies of five pairs of successful and unsuccessful privatizations in five selected industries, an assessment of their effects to LG financing, an analysis of the effects of different privatization models and one of the key privatization-related issues – ownership on construction land – NALED provides an overview of paradigmatic examples of "good" and "bad" privatizations. The selected industries have undeniable development potential for Serbian economy (agriculture, mining, pharmaceutical industry, metal industry, paper production). The companies analyzed in the case studies were selected carefully so as to ensure that the companies are true peers – comparable in size, market share before privatization – and at the same time to represent key privatization models and feature some of the key problems in the privatization process in Serbia. Preference was given to companies from SLDP IMCs.

The data for the analysis was obtained from local governments, the companies included in the studies, and other publicly available sources.

The new Privatization law envisages the completion of the privatization process in Serbia by December 31, 2015. Based on the case studies, NALED has formulated recommendations for both central government and local governments on how to finalize this process efficiently and ensure that the best results for all are achieved.

CASE STUDIES

1. PAPER PRODUCTION –DUROPACK (KRUSEVAC) AND FOPA (VLADICIN HAN)

Duropack (formerly Dusan Petronijevic) was privatized in the second half of 2004, through a public tender. In the course of preparations for the privatization process, the company has taken comprehensive restructuring measures, including the reduction of the number of employees bz almost 40% The buyer, an Austrian company which operates in the same industry, purchased 70% of the socially-owned capital. Prior to privatization, the companies capacities were underused, it had surplus workforce and negative business results. After privatization, the company operates successfully – its income is doubled, while the market share has increased by more than 50%. In addition to considerable investments, the buyer has taken a number of restructuring measures: quality of the production process was improved, integrated management system introduced…Consequently, the company's fiscal contribution has also increased, and has generated more revenues for both central and local government. The company is an example of privatization where the strategic partner takes full control of the company, and is an often cited success story.
The destiny of the FOPA company is quite the opposite. In 1999, FOPA was one of the most important companies on the LG level, with as much as 850 employees, today the company is bankrupt. FOPA was one of the first companies privatized pursuant to the Ownership Transformation Act and is a typical case where the employees become shareholders but fail to change the company's operation in organizational, technological, financial and management terms. In addition, it is case of evident conflict of interest between the employees as shareholders (maximize the price the shares) and employees as workers (retain all jobs).
In terms of importance of the company for the LG, FOPA was much more important for its local government, given its size compared to other companies in Vladicin Han and the degree of development in the municipality. The study shoes that the company's failure causes a loss of between 4,3% and 5,7% of direct municipal revenues annually.

2. MINING – RUDNIK (GORNJI MILANOVAC) AND SUVA RUDA (RASKA)

The privatization of Rudnik was a typical example of the buyer not being fully informed of the status of the privatized entity, which was a major problem in the privatization process. The buyer was not aware that bankruptcy procedure was opened with regards to the company being privatized. In addition, there were considerable liabilities of the company which were not included in the privatization documentation. The buyer, after having obtain 70% of ownership of the company's capital, has carried a debt-to-equity swap, purchased shares from minority shareholders and as of January 2012, became a sole shareholder.
Both the management of Rudnik and the employees have had a positive attitude towards privatization, and hence the buyer did not encounter major problems with employees. The structure of employees has changed since privatization, but their number has remained at almost the same level, which is rather rare. In the 2004-2013 period, Rudnik has contributed a total of 193.6 million dinars to the Gornji Milanovac budget solely through personal income taxes.
In the case of Suva Ruda, the main problem was the lack of investors' interest in privatization and was sold only in the fourth attempt to a concern which has owned a number of lead, zinc and antimony. The buyer has announced the start of production on a number of occasions, but

this was never effected and the company has not engaged in its primary activity after privatization. Given the company's importance for the Raska municipality, further delays in investment and start of operation will have an adverse effect on the municipality's fiscal status.

3. METAL INDUSTRY – GOSA MONTAZA (SMEDEREVSKA PALANKA) AND ZAVARIVAC (VRANJE)

Whilst Gosa Montaza operates successfully, Zavarivac has been in the restructuring process for the past three years. The adverse position of Zavarivac is partly caused by unsuccessful privatization – it was first privatized through ownership transformation, and then the strategic partner has bought the majority share package. Gosa Montaza, on the other hand, is a rare example of a success story where the employees as shareholders. It should be noted though that Gosa's employees did not obtain their shares free of charge, but have purchased the majority share package at a public auction. Following privatization, Gosa Montaza has increased efficiency, invested in equipment (a total of 4 million EUR), introduced the integrated management system…On the other hand, Zavarivac has managed to remain operational due to soft budget constraints, that is, accumulated liabilities towards state-owned creditors, employees and suppliers. As an illustration, Zavarivac owes some 50 milion dinars of personal income taxes in 2014. The study shows that the failed privatization of Zavarivac has cumulatively created a 13.5 milion EUR worse business results in the 2009-2013 period than the alternative scenario would have (had Zavarivac operated as Gosa). „

4. PHARMACEUTICAL INDUSTRY – ZDRAVLJE (LESKOVAC) AND JUGOREMEDIJA (ZRENJANIN)

The privatization process in Zdravlje has begun in 1990-ies. In October 2002, 70% of socially-owned capital was sold for a relatively low price of 3.5 million EUR to the sole interested byer „Pharmaco hf". Such low price was caused not only by lack of interest on the part of the potential buyers, but also by considerable expenditures for the social programme. Presently, Zdravlje is part of a globally integrated pharmaceutical company Actavis plc. Until 2008 the company has invested over 31 milion EUR in the development of its production in Serbia, as envisaged in the privatization contract. The company has continued to invest and the amount invested now totals 50 million EUR. In addition, the Zdravlje has undergone a series of operative restructuring measures, improved the quality of its production and its overall operation.
On the other hand, the case of the Jugoremedija privatization is extremely complex. Jugoremedija is among rare companies that were "re-privatized" after the privatization under the Ownership Transformation Act – namely, the remaining package of shares owned by the state was sold, and then the capital was increased. Following the rescission of the privatization contract and failed recovery of the company, Jugoremedija is presently in bankruptcy.
The difference between the two companies is best illustrated through a comparison of the business results. The failed privatization of Jugoromedija has cumulatively created a 13.4 million EUR worse result in the 2003-2013 period, compared to the alternative, successful scenario.

5. AGRICULTURE – BANATSKI DESPOTOVAC (ZRENJANIN) AND MALA BOSNA (SUBOTICA)

The faith of the two agricultural companies following privatization is considerably different. Whilst Banatski Despotovac continues to operate with relative success after privatization and considerable investments, Mala Bosna is undergoing restructuring following the rescission of the privatization contract. Due to credit debts towards banks both companies have constituted mortgages on a considerable part of their immovable property, using them as collateral. The privatization of Mala Bosna reveals numerous weaknesses of the privatization process in Serbia: lack of mechanisms that would prevent money laundering, the use of entity being privatized as collateral, links between domestic banks and buyers, deficiencies in the control process, and the like.

KEY CONCLUSIONS

Case studies clearly indicate that the strategic investor is instrumental in the success of privatization – an investor which can transfer technology, carry out operational restructuring and invest in equipment. Such investors are, as a rule, not ready to take on additional risks such as excess workforce, unresolved ownership issues and financial liabilities, in an unfavorable environment for doing business..

It is in the interest of local self-governments for all the resources of the company being privatized to be efficiently used as soon as possible. Studies show that one of the consequences of unsuccessful privatization is the accumulation of debts towards local self-governments and public utility companies. As a rule, LGs have taken a passive role in such cases. Given that, as a rule, LGs are most often unsecured bankruptcy creditors and the collection rate in the bankruptcy process is very low.

The effects of unsuccessful privatization vary, given the relative position of the company in the specific LG. In some cases, the contribution of such companies to the LG budget is considerable and amounts to several percentage points; however, the opportunity cost is even higher and amounts to millions of EUR. In the case of pharmaceutical companies alone it amounted to 31.6 million EUR in the 2007-2013 period.

The new regulatory framework has eliminated some of the problems (e.g. the issue of over-indebtedness), but the problems of surplus workforce and land ownership remain unresolved.

When it comes to surplus workforce, there are two situations – when the number of employees needs to be reduced before privatization and when it is possible to settle the debts towards employees in the bankruptcy process. In order to resolve the issue of surplus workforce in companies that are now in the Privatization Agency portfolio, the relevant secondary legislation (decision) needs to be changed and budget allocations for the Transition fund needs to be increased. Currently, the budget envisages that only 23.5 milion EUR will be used for that purpose as opposed to some 50 milion EUR in 2011. Otherwise, the entire process may be undermined.

One of the key unresolved issues related to the rights of privatized entities and their owners is whether the state will recognize their ownership on construction land, and under which conditions. Namely, in the privatization process the buyers have obtained the land use right, which was the widest scope of right on construction land at the time and it also entailed the right to build. A constitutional court decision passed in 2013 has invalidated the provision of Article 103 paragraph 1 of the Planning and Construction Law and de facto prevented further conversion of the right to use land to ownership right over construction land. Given that the right to build based on the right to use land is also disabled through the changes in the ownership regime on such land construction land is now de facto blocked for investment. Failure to resolve this issue shall also undermine the privatization process.
Except for a number of large companies undergoing restructuring, it is not realistic to expect major brownfield investments in Serbia. A business enabling environment is key in making a decision to invest, be it through privatization or a new (greenfield) investment. Whilst many

components of a business enabling environment are exogenous, that is, given on the national level, some very important factors and endogenous and are in the competence of local self-governments. Although a number of municipalities have improved their business environment, there is still ample room for improvement. One of the key factors on the local level are the construction land charges, but also other fees, such as the signage fee. Whilst the construction land charge is an important source of revenue for the local budges, revenues such as signage fees are not as important, but their amount is provisionally determined by the LGs. Further abolishment of quasi-fiscal charges on the local level may considerably reduce the cost of doing business, particularly in cases of micro and small companies.