OWNERSHIP RESTRUCTURING

IN

YUGOSLAVIA

PREPARED
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EXECUTIVE SUMMARY

The best option for ownership restructuring in Yugoslavia is to give without payment the ownership of all enterprises to three institutions: banks, pension funds, and newly created holding companies. In turn the ownership of the holding companies and banks would be given without payment to all citizens of Yugoslavia. If judged to be fair, some of the shares in each enterprise could be given to the workers of that enterprise.

Recommended Ownership

	% of Shares
Free distribution to:	
Pension Funds	45
Holding Companies	30
Banks	10
Workers	15
TOTAL	100

Ownership restructuring is needed because the system of social capital and worker self-management has proven to be a failure. The recent Federal and Republic laws to reform the system of ownership, however, are not likely to result in an improvement. These laws create a new type of "mixed" enterprise combining private and social ownership. Instead of experimenting with a new form of ownership, it is best to follow the established model in Western economies.

Other options for ownership restructuring were analyzed but found to be inferior to the recommended option. One option is to transfer ownership to the State. State-owned enterprises have proven to be inefficient and large loss makers.

A second option is to sell enterprises to foreign investors. Foreign investors are likely to be good managers of enterprises and bring in needed expertise and capital. Such sales, however, are likely to take a long time to complete. Also the sales price would be low because of the political and economic uncertainty; and, as a result, this option would be unfair to Yugoslav citizens.

A third option is to sell enterprises to Yugoslav citizens. Even if all existing savings and all future savings were used to buy shares in enterprises, this would take ten to twenty years to complete. The resulting ownership structure will do little to improve "corporate governance", i.e. the way enterprises are controlled and managed to assure that they are as efficient and profitable as possible. Also such sales are likely to be unfair to the majority of Yugoslav citizens who can not afford to buy shares. A more serious problem is that such sales would absorb savings and capital that would otherwise have been used by the enterprises to modernize and grow. There is no satisfactory way for the State to "recycle" the proceeds of sale back to the enterprises.

A fourth option is simply to give shares in the enterprises to all citizens of Yugoslavia without payment. Though this would be quick and fair to all citizens, the ownership of each enterprise would be spread among thousands of individuals. Such dispersed ownership is not likely to improve corporate governance. It would be little different from social ownership.

Compared to the other options analyzed, transfer of ownership to institutions is the only option that (i) would improve corporate governance, (ii) could be done quickly, and (iii) would be fair to all citizens. More than any other possible Yugoslav owners, these institutions are likely to be able to monitor and control enterprises to assure that they are efficient and profitable.

This option will reduce the need to raise taxes to pay for pensions and to rehabilitate the banks. Pension funds will have additional revenue to pay pensions, and the banks will have additional capital to pay their depositors. Another benefit is that these institutional owners can sell enterprises to foreign investors when the economic and political climate has improved. The most important unresolved issue with the recommended option is how it can be coordinated with financial restructuring of insolvent enterprises and banks.

The main body of this report (excluding the annexes) has been translated into Serbo-Croation. A copy can be obtained from:

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I. INTRODUCTION

Many Yugoslav economists have long been critical of the system of worker self-management of enterprises introduced at the beginning of the 1970s by the Constitution of Yugoslavia and the Law of Associated Labor. The main criticism was the economic inefficiency of the system, primarily caused by poorly defined property rights. Dissatisfaction with the system of social ownership and self-management has led to various proposals to alter the system, especially to alter the concept of social ownership on which the self-management of enterprises is based.

Reformist thinking up to 1988 in Yugoslavia was mainly oriented towards making the self-management system more efficient, for example, by redefining the concept of social ownership and introducing more elements of a market economy. Since that time, however, the reformers have been more and more inclined to believe that the full introduction of a market economy with private ownership of capital is necessary if reform is to be successful. This was often called "ownership restructuring" or "privatization", since most of the proposals involved transferring socially-owned capital of enterprises to private individuals and institutions.

Ownership restructuring is just one part of a broader program of economic restructuring in most Eastern European countries including Yugoslavia though many would argue that ownership restructuring is the most important part. In general, the goal is to introduce a market system based on private ownership and competitive markets.

Western economists have studied at great length the workings of capitalist economies, but until recently almost no one had analyzed how to transform economies in Eastern Europe from a socialist system to a capitalist system. Since 1989, however, the debate about economic restructuring has been intense among government officials and academics in Eastern Europe, in Western countries, and in international organizations such as the World Bank. In the meantime, Eastern European countries are suffering from a severe economic depression that makes restructuring all the more urgent.

There is no single model of restructuring that everyone agrees should be followed, and each country of Eastern Europe is trying different approaches. Also these countries have modified their approaches over time based on experience and new proposals or models, and this experimental approach is likely to continue.

Yugoslavia is no exception. Federal laws on economic restructuring have undergone continuous review and have been changed on a number of occasions. The Republics of Yugoslavia are also debating and experimenting with various approaches to economic reform.

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[1] This report is a joint effort of the Economics Institute of Belgrade and the Washington D.C. office of Coopers & Lybrand (an international accounting, auditing, and management consulting firm). It has been prepared under the general direction of Dr. Robert E. Anderson (Coopers & Lybrand) and Prof. Zoran Popov (Economics Institute). The review was funded by the United States Agency for International Development under Contract Number ANE-0014-C-00-0058-00. Various sections were prepared by Dennis Fish from Coopers & Lybrand and the following individuals affiliated with the Economics Institute -- Prof. Miroljub Labus, Prof. Ljubomir Madžar, Dr. Boško Mijatović, Prof. Ivan Vujačić, and Prof. Duško Vujović.

Since 1979, the Yugoslav economy has been in a crisis. During 1980-90, its growth rate was almost zero.[2] The economic crises worsened in 1990, when national income declined by about 8 percent.[3] Further and much more severe deterioration of economic activity took place in 1991 -- according to official estimates, total production is expected to decline by more than 20 percent[4]. Sharp reduction in output has hit all the Republics, with a decline ranging from 14 to 28 percent. The rate of decline has intensified in the last few months of 1991. As a result of the continuation of war and severe political and economic disagreements between the Republics, the decline in economic activity is expected not only to continue but to intensify in 1992.

There is no doubt that the decline in economic activity is partially due to the war and grave political problems facing the country. It is also true, however, that the slowdown in the implementation of economic reforms has aggravated the economic crisis. Consequently, all of the Republics are going to face severe social and economic problems in 1992. Despite that, this study does not examine the entire problem of restructuring and revitalization of the Yugoslav economy but instead focuses on only one issue -- how to find or create better owners of social capital, i.e. owners that will have strong natural interest and motivation to protect and enlarge their capital.

These trends indicate that the Yugoslav economy needs a thorough and rapid reorganization or reform. Unless a reform is undertaken in the near future, the whole economic life of the country will approach a standstill. Until the self-managed economic system is abolished and a market economy is introduced, there is little reason to hope that performance of the economy will improve even if the war and political problems end.

Economic activity of the country could be temporarily revived with quick and massive monetary expansion, but this would cause hyperinflation. A stop and go economic policy was practiced during the last two decades, but the economy continued to deteriorate. It culminated in hyperinflation followed by a sharp decline in production after 1989. If monetary expansion is to be used again as an instrument of economic policy to combat the economic crisis, it is more likely that hyperinflation would reappear in a very short period of time.

The economic crisis exists primarily in the social sector of the economy. The private sector does not appear to be suffering nearly to the same extent. In the past, the economic system favored only the social sector, while the private sector was suppressed by legal and economic policy measures of the government. This explains why the private sector did not experience much economic growth in the past but began to flourish as soon as it was allowed to operate on an equal footing with the social sector.[5]

Because of the system of self management, Yugoslavia has suffered from low growth or declining efficiency. Productivity of capital in Yugoslavia began to decline in 1964, while productivity of labor experienced slow growth in the 1970s and was negative in the 1980s. As a result, global productivity of the economy has been stagnant since the mid 1960s and began to decline before the end of the 1970s.[6]

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[2] *Statistical Yearbook of SFR of Yugoslavia*, various issues.

[3] *Statistical Yearbook of SFRY,* 1991.

[4] *Politica,* 20. XII. 1991.

[5] Official sources indicate that in the period 1989-91 about 50,000 small private firms and shops have been created. See *Borba*, 15.5.1991.

[6] Popov (1989).

Market oriented reform in Yugoslavia is not likely to progress unless socially-owned capital is privatized. Social ownership is spread over the entire economy, but it does not follow that the privatization program must be the same in all sectors. In that respect it is possible to distinguish three sectors of the economy.

The first sector, small enterprises and shops, could be privatized by sale, franchising, contracting out, renting and similar methods. The whole idea would be to transfer them quickly into private firms and enable them to be managed by private entrepreneurs. The emphasis here is not so much on transfer of ownership rights, although this is also important, but on the introduction of private entrepreneurship in the management of a large number of small firms.

The second sector, socially-owned flats or apartments, should be the subject of a special privatization program. Since society has no interest in owning and managing the flats, especially if it has to subsidize the rents, the only solution is to sell them to the tenants. The price and conditions of sale should be set so as to motivate the tenants to buy the flats they occupy. The sale of socially-owned flats should be designed as a part of broader market-oriented reform of the entire housing sector.[7]

The third sector, large industrial socially-owned enterprises, is the core of the Yugoslav economy. Privatization of these enterprises is the central topic of this report for two reasons. First, the poor performance of these enterprises is the main cause of the economic crisis. They produce most of the financial losses and are also the least efficient part of the economy. Second, self-management in the large-scale enterprises has proven to be a poor way of governing them. The workers have proven to be incapable of managing the enterprises either because of a lack of knowledge or lack of interest.[8] Instead, the economy in general and the large-scale enterprises in particular have been in fact governed and controlled by the government and the Communist Party.

In this report, we analyze the debate that has gone on concerning ownership restructuring of these large enterprises, the experience to date in Yugoslavia and other Eastern European countries, the systems of ownership and privatization experience in Western countries, and the various options that have been proposed. Though in the end a particular option is recommended as being the best for Yugoslavia, we also present the arguments for and against the other options so that the readers can make their own choice.

Four broad categories of options are analyzed in this report:

1 Government ownership. One way of clarifying the question of who owns the social capital is for the government to take over ownership. Either the Federal or a Republic government would, in effect, nationalize the enterprise without paying for it. Assuming that the enterprise is in corporate form, the government would appoint the board of directors to control the enterprise and receive any dividends paid by the enterprise. The key issue concerning this option is whether it will improve the management and efficiency of enterprises.

2 Sale of the social capital. The social capital can be sold to domestic or foreign buyers. The existing laws on ownership restructuring at the Federal level and in the Republics rely on the sale option. Sale was also commonly used in Western countries when government-owned enterprises were transferred to private investors and seems to be a large part of the programs for ownership restructuring in other Eastern European countries. The key issue is whether a fast sale program is likely to be fair or improve the management and efficiency of enterprises.

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[7] Further information about the privatization of small-scale enterprises and flats in other countries can be found in Annex F (Western economies), Annex K (Hungary), Annex L (Czechoslovakia), and Annex M (Poland).

[8] Nove (1983).

3 Share give-away. Socially-owned enterprises could be converted into joint stock companies and the shares simply given away directly to Yugoslav citizens. A number of proposals have been made to give away shares including the use of so called "vouchers." Major issues with this option are its administrative practicality and the resulting improvement in the management and efficiency of enterprises.

4 Transfer to institutions. Instead of shares going directly to citizens, the shares could be given to various kinds of institutions such as holding companies, mutual funds, pension funds, and banks. These institutions would in turn be owned by all Yugoslav citizens. A key issue here is the ability of these institutions to monitor and control the enterprises that they would own.

One final remark is necessary. It concerns the political future of Yugoslavia, which for the time being looks dim. In the study we did not ignore this fact, but it is not particularly relevant to the conclusions of the study. The main findings of the study are equally applicable to the country as a whole or to the individual Republics.

II. ECONOMIC RESTRUCTURING

For many years Yugoslavia prided itself on having an economic system that avoided the worst problems associated with either the centrally-planned communist economies in other Eastern European countries or the capitalist systems in Western countries. In many ways, the Yugoslav system was a unique experiment that did perform better than other Eastern European economies. This system, however, has not performed as well as Western capitalist systems. Thus many Yugoslavs believe that the economic system should be restructured along the lines of Western countries. Instead of experimenting with new economic systems with unpredictable results, it is best to follow an established system with well-known strengths and weaknesses.

The previous Yugoslav economic system was complex and evolved over time. The essence of the system, however, was to combine a market economy with "social ownership" and worker self-management of enterprises. Capital was owned by society in general, but actual management and control of the capital was placed in the hands of the workers council in each enterprise. Compared to some other Eastern European countries, each enterprise was relatively autonomous and free to develop its own business strategy for competing in the market.

In this way, it was hoped that the efficiency of a market economy could be achieved without exploitation of workers and large inequalities of income and wealth. Using the market to set prices of most goods and services and permitting competition among enterprises would achieve the same economic efficiency and high income levels found in successful capitalist countries but would avoid the rigidities of Soviet-style central planning.

Annex A provides a detailed description of the problems and inefficiencies created by this system. The basic weakness is that the workers councils managed the enterprises but did not own the capital invested in the enterprises. This resulted in a poor system of enterprise management or what has come to be called "corporate governance" by Western economists.

Some of the inefficiencies that resulted were:

- prosperous firms managed by their workers councils tended to hire too few workers and used more capital-intensive methods of production. This increased the income for the existing workers but caused unemployment and low wages for other workers;

- loss-making firms or firms in declining sectors of the economy were unable to fire workers, and thus labor did not move from sectors where it was surplus to where it was needed;

- enterprises suffered from cumbersome decision-making processes that resulted in slow responses to changes in the marketplace. This was a crippling disadvantage in competing with foreign firms;

- because of excessively high wages, products produced in labor-intensive industries were overpriced and thus the demand for these products was reduced. This particularly hurt those less developed regions of the country with abundant labor where such labor-intensive industries would logically be located; and

- capital was not mobile and could not freely move from a low value to a higher value use. This was because the workers in an enterprise could not exercise control of the capital if it was invested outside of the enterprise.

As a result of these and other inefficiencies, it was impossible to maintain macroeconomic stability leading to declining savings, low growth, inflation, and the current liquidity crisis. The initial cause was a low level of retained earnings and thus investment. Self-managed enterprises paid too high a proportion of revenues as wages and other forms of income to workers. This occurred in spite of government regulations and controls designed to limit the proportion of enterprise revenue paid to workers.

The low level of investment resulted in slow growth and threatened to cause unemployment. The Communist Party and government officials then insisted that existing enterprises hire more workers to avoid unemployment. This further increased the proportion of enterprise revenues paid out as wages, thus reducing savings and investment still further.

The end results of this chain of events were:

- low and declining productivity of both capital and labor for at least the last twenty years; and

- low efficiency of investments in the whole period since 1945. The problem became especially serious in the last two decades resulting in large imports of foreign capital. As a result of low efficiency of investment, the economy needed more and more capital to preserve the same or even lower rate of GDP growth.

To obtain the necessary funds to pay its workers, an enterprise often resorted to borrowing from banks and delaying payment to creditors. Because the banks in Yugoslavia are owned by the enterprises and due to pressure from the government to avoid unemployment, the banks were willing to make these loans. The banks in turn borrowed from the National Bank of Yugoslavia which led to an increase in the money supply and inflation. Thus Yugoslavia has had a number of periods of high inflation.

To control inflation, the National Bank of Yugoslavia has often had to introduce a tight monetary policy leading to high rates of interest and reduced liquidity. A final action that an enterprise can take to raise the money to pay workers is to cease paying creditors leading to a larger and larger "accounts payable." This has resulted in the general state of illiquidity where no enterprise has cash.

Economists and many government officials recognized these deficiencies in the system of social capital. Years of reforms and experimentation, however, have demonstrated that social-ownership and self-management is basically incompatible with an efficient market economy. In fact, past Yugoslav economic reforms have been a series of unsuccessful attempts to fix a system that cannot be repaired but instead needs to be replaced.

Though Yugoslavia has had more of a market economy than other Eastern European countries, Yugoslavia needs to make many changes to its political, legal, financial, and other institutions in order for an efficient market economy to operate. This report will not attempt to analyze all of the changes that are needed but instead will focus on the changes needed in the ownership structure and system of corporate governance.

III. WESTERN ECONOMIC SYSTEMS

A. SOURCES OF CAPITAL

If Yugoslavia is to follow the Western economic model of ownership, it is necessary to understand the key characteristics of Western corporations. The capital that a Western corporation needs to expand and grow comes from two basic sources (this is discussed in more detail in Annex B). The first is loans (loans from banks, selling corporate bonds, credits from suppliers, etc.). The return to lenders is the interest rate that they receive on the loans. As discussed below, lenders also assist in supervising and monitoring the performance of the enterprise ("corporate governance").

"Equity" is the second source of capital. This is the money provided by the owners of the company who have purchased the shares (also called common stock) of the company. Shares are owned by other corporations, individuals, governments, banks, mutual funds, pension funds, and insurance companies. The return on the equity capital is the dividend payments made by the company to holders of shares. Unlike interest rates, dividend payments are not fixed and may vary with the profitability of the company. The amount of dividends to be paid is decided by the board of directors of the corporation. Corporations obtain equity capital by selling shares to investors (a "new" share issue) and by retaining some of the company's profits for reinvestment in the company instead of paying dividends to the shareholders.

B. CORPORATE GOVERNANCE

"Corporate governance" is a term used to describe how the owners of an enterprise (the "shareholders") control the professional managers to make certain that they are doing the utmost to maximize the value of the owners' investment. Corporate governance is not usually an issue in small enterprises (a farm, a family owned bakery, an automobile repair shop, etc.). In these enterprises, the owner is usually also the day-to-day manager.

Corporate governance becomes an important issue in large corporations that may have thousands of owners none of whom participate in the day-to-day management of the enterprise. There is considerable variation from country to country in the ownership structure and system of corporate governance. (A more detailed analysis of ownership and governance in Western countries is provided in Annex B.)

In most countries, the shareholders (owners) at their annual meeting elect members of the board of directors. The board of directors then meets typically once a month to oversee the management of the enterprise. Members of the board are usually experienced businessmen who have the skills to judge the performance of the company. The board appoints the senior managers of the company and determines their compensation. Often their compensation is tied to the performance and profitability of the company through "stock option plans" and bonuses.

If owners are dissatisfied with management of the enterprise, they can elect a new board of directors. A corporation typically issues detailed financial statements following generally recognized accounting principles to allow the owners to judge its performance.

Beyond electing the board of directors, owners have other means of exercising control. In the United States and Great Britain, the stock market plays the dominant role. The prices of equity shares rise and fall depending on the performance of the companies. If an enterprise is performing badly, a new owner may buy up the low-priced shares, take over control of the enterprise, appoint a new board of directors, replace the top managers, and introduce a new strategy or plan for improving performance. The possibility of such "takeovers" is a strong incentive for existing managers to find ways of improving performance.

In continental European countries and Japan, banks often own a sizeable proportion of a company's shares and also provide loans to the company.[9] Thus the banks have an incentive to make certain that the enterprise is well managed and profitable. Such a bank will often have representatives on the board of directors who have the experience and expertise to monitor performance.

Banks and other lenders to a company also play an important role in corporate governance. Before lending money to a company, a bank or other lender often requires the company to agree to certain conditions before granting the loan. The requirements or conditions are designed to assure that the company can repay the loan. For example, a common condition is that the earnings or cash flow of the company must not drop below a certain multiple of the interest payment on its outstanding loans. Also "rating agencies" evaluate and rank the financial soundness of enterprises as a guide for lenders. For example, Moody's and Standard and Poors are the two largest rating agencies in the United States. If a company runs into financial difficulties, the lenders have an incentive to intervene and assist in restoring the profitability of the company. In particular in Germany and Japan, the banks as both lenders and owners of enterprises play an important role in helping enterprises in financial trouble.

C. ROLE OF INSTITUTIONAL OWNERS

A significant trend in all of these countries is the increasing importance of share ownership by institutions such as banks, pension funds, mutual funds, and insurance companies. The are also referred to as "financial intermediaries" because they stand between the individual investor and the enterprise. Instead of buying shares of corporations directly, individuals provide money to one of these financial intermediaries which pools their money and buys shares in many corporations.

A financial intermediary offers three advantages compared to the case of an individual buying shares directly. Such a financial intermediary will:

- own shares in many corporations and thus not be dependent on the success or failure of just a few corporations;
- evaluate the financial prospects of each corporation and purchase the shares of those corporations which are likely to be the more profitable and successful; and
- monitor and exercise control over the management of the companies in which it has purchased shares to assure that the companies are as efficient and profitable as possible.

At the same time that financial intermediaries are owning a larger proportion of shares in Western companies, they are also becoming more involved in the management and control of enterprises to ensure that the value of their investment grows. These intermediaries have the ability to evaluate the performance of enterprises which most individuals would not have.

D. LESSONS FROM WESTERN EXPERIENCE

The lessons that Yugoslavia can learn from this Western experience with corporate governance are:

- no limits should be placed on the new owners of an enterprise to control the enterprise and its managers;

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[9]For historical reasons, banks in the United States are not permitted to be owners of non-financial enterprises.

- large institutional owners and financial intermediaries (mutual funds, pension funds, banks, etc.) are better able to monitor and control enterprises than are many small owners; and

- no restrictions should be placed on existing owners selling their shares to new owners. In this way ownership can be transferred to those who have a better plan for managing the enterprise.

IV. THE FAIR DISTRIBUTION OF SOCIAL CAPITAL

An important issue is how will the new ownership structure affect the distribution of income and wealth in Yugoslavia. Transferring ownership of social capital to private individuals and institutions means that specific individuals will receive the income earned by that capital. In Western countries, individual owners of shares in a corporation receive dividends paid from the profits of the enterprise. These individuals can also sell their shares which may have increased in value if the company is growing.

No one knows for certain what the social capital in Yugoslavia is worth or what the future owners will receive as income from that capital. Estimates of the value of social capital range between $60 and $130 billion.[10] If this wealth were divided equally amongst the entire population of Yugoslavia, each person would receive assets worth between $2,500 and $5,000.[11]

In Western countries, ownership of capital is very uneven. This distribution of ownership is the result of historical circumstances and is not necessary for the efficient functioning of a market economy. An important question for Yugoslavia is what should be the initial distribution of the social capital to the citizens of Yugoslavia if the decision is made to transfer ownership to private citizens. This is essentially a question of what is fair and equitable.

A. LEGAL BASIS OF SOCIAL CAPITAL

The legal and philosophical basis of social capital is that it belongs to society in general rather than to particular individuals, workers, or the Federal, Republic, and local governments.[12] Though workers in an enterprise managed the social capital, they did not legally own the capital in the way that shareholders own the capital in a Western corporation. Thus, based on current law it is difficult to say that any group of citizens has a greater claim to owning the social capital than any other group.

One group that might make a claim to own a greater share are the workers in the socially-owned enterprises. Because workers managed the enterprise and exercised many of the rights of an owner, many have come to believe that they are the owners of the social capital invested in the enterprise in which they work. This has been encouraged by Marxist principles such as the labor theory of value.

If this claim by workers is found to be valid, another issue is that workers in profitable enterprises would have a claim to own social capital that was more valuable than would workers in unprofitable or loss-making

[10]The higher value is found in Annex C. The lower value is found in Radmilovič (1991).

[11]In presenting numbers, the United States' convention is used. Namely a comma (,) is used to separate thousands while a period (.) is used to separate decimals.

[12]This interpretation is supported by a number of constitutional provisions. In particular, Chapter III of the Statement of Basic Principles states that no one (the government, the enterprise, the group, or the individual) may either earn income or manage the means of production on the basis of authority derived from the rights of ownership. This chapter makes it clear that individuals may not be endowed with any property rights relating to social capital. Consequently, it belongs equally to everyone.

enterprises. The high value of the social capital in the profitable enterprises may have little to do with the effort or performance of the workers in that enterprise and may largely be due to good luck. Meanwhile the social capital in unprofitable enterprises may have low value because of circumstances beyond the control of the enterprise or the workers.

B. CONTRIBUTION TO SOCIAL CAPITAL

Another basis for judging what is a fair and equitable distribution of ownership of the social capital might be the contribution or sacrifice that each individual made to accumulate the social capital. In analyzing this issue, it is necessary to distinguish between the two main sources of financing -- loans and equity.

Some of the social capital was paid for through bank loans. These funds were provided by the citizens who have deposits in the banks. Thus these holders of bank deposits have a clear claim on the social capital equal to the value of the bank loans that are outstanding.

What is open to dispute is the ownership of the remaining portion of the capital not financed through loans or other credits. In Western countries, this is called the "equity" capital. As indicated above, estimates of the value of this portion of the social capital range between $60 and $130 billion. (Annex D attempts to determine who contributed this portion of the social capital.)

This "equity" portion of the social capital could have come from the following sources:

- contributions by Federal, Republic, and local governments;
- nationalization of property owned by private owners in the early postwar period;
- voluntary reductions in the income paid to the workers and managers of the enterprise;
- an "inflationary tax" on bank depositors; and
- reinvesting the return or "profit" earned on the social capital to create more social capital.

With regard to the first source, any contributions made by a governmental authority does not give any particular group of individuals a special claim to the social capital. This contribution was made by government representing society in general.

With regard to the second source, contributions that resulted from nationalization of privately-owned property raise the possibility that these former owners do have a special claim to part of the social capital. Annex D briefly reviews the history of nationalization after the Second World War to determine if former owners were fairly compensated. The issue of whether and how former owners should be compensated is essentially a political issue to be determined by governmental authorities or the courts.

With regard to the third source, contributions made by workers and managers towards increasing the social capital, the historical evidence is that workers and managers probably earned excessive incomes from their management of the social capital. There is little evidence that they sacrificed or reduced their incomes to increase the social capital (see Annex D for more details.) Since workers did not own the social capital, their incentive was to take as large a share of the enterprise revenues for themselves as was permitted by the government.

With regard to the fourth source, the inflationary tax occurs when unexpected inflation reduces the real value of bank loans, but interest rates are not high enough to compensate. The various periods of high inflation in Yugoslavia have meant that much of the social capital was an involuntary contribution by the banks and thus their depositors.

Finally, much of the social capital came from the return or "profit" earned by the social capital itself. After the payment of wages and personal incomes, taxes, and operating expenses, the revenues of the enterprise were reinvested in modernization, new equipment, and the expansion of productive capacity. Thus seems that the social capital itself made the largest contribution towards the growth of social capital.

C. CLAIMS BY WORKERS AND FORMER OWNERS

In conclusion, two possible groups of people may have a claim for a greater share of the social capital than other groups:

- former owners whose property was nationalized without fair compensation; and

- workers in socially-owned enterprises who have a claim based on tradition and Marxist theory.

If it is decided that these two groups do have a greater claim, they could be satisfied in a number of ways. The controversial issue of compensation for previous owners need not delay ownership restructuring. Though previous owners may deserve compensation, it is not necessary to return to them the specific property that was taken from them through nationalization. Instead, it would be preferable for the government to establish special agencies or tribunals that can evaluate the claims of previous owners under guidelines established by the government. If judged to be fair, monetary compensation can be provided rather than returning the specific property that was taken from the previous owners. This process can occur after ownership restructuring.

If workers in an enterprise are judged to have a greater claim to ownership than other groups, this claim can be satisfied in two ways:

- if the social capital is to be sold, then workers can be given the right to buy some of the shares in their enterprise at a discount or given some shares at no cost. This approach has been followed in the Federal and Republic laws on ownership restructuring; or

- if the social capital is to be distributed free to all citizens (one of the options discussed below), workers can be given a larger proportion of the shares than other citizens.

With the possible exception of these two groups, all citizens should benefit equally from the restructuring of ownership and distribution of the social wealth.

V. THE NEED FOR RAPID OWNERSHIP RESTRUCTURING

Another important issue in analyzing options for ownership restructuring is how fast will the restructuring take. Is this a process that will take a few months, years, or even decades to complete? Should a particular option be preferred because it promises a quick restructuring?

A quick ownership restructuring is needed in order to complete the reforms of the economy begun over the last three years and to aid economic recovery. These partial reforms have left the economy in a precarious position, and the reform process needs to be completed as soon as possible.

A. MARKET ORIENTED REFORMS

Market oriented reforms of the Yugoslav economy began in 1988. In order to initiate the process of reform, it was necessary to amend the Yugoslav Constitution of 1974 and to make the Associated Labor Act largely ineffective. As a result, the former economic system, based on self-management and social ownership and on an elaborate mechanism of self-management agreements and social compacts, has undergone substantial revision.

In addition, a number of new laws were enacted. In particular, the Law of Enterprises made it possible for Yugoslav firms to organize as Western companies, i.e. the former legal obligation to organize all firms as "organizations of associated labor" was abolished. It also eliminated the monopoly of social ownership, so that all ownership forms became equal from the legal point of view. The Law on Social Capital made it possible to privatize social capital. Even though the Law makes it possible to privatize completely socially-owned enterprises, the main result of the Law is likely to be partial privatization of social capital and creation of "mixed" enterprises.

In addition, foreign trade and prices were liberalized. Thus the competitiveness of the domestic market has increased considerably. Hyperinflation was also brought under control.

For a complete understanding of the Yugoslav economic situation, one must also understand the major changes which occurred in the political system. The most significant change is that the monopoly of one political party was abolished. The government is no longer an extended arm of the ruling Communist Party. The country's League of Communists ran not only the state but the entire economy through the self-management system. With the abolishment of the single party, a vacuum emerged which can be eliminated only with the establishment of a new political and economic system. For this reason, the implementation of quick and radical reforms are very urgent.

Because of partially implemented reforms and the cessation of market oriented reforms, the present Yugoslav economy is a special sort of a mixed economy, i.e. a mixture of socially-owned and privately-owned enterprises. Social ownership is still dominant, but legal rights of the society (government) to monitor and control the enterprises have been largely dismantled. The enterprises are in fact organized like cooperatives. The owner of social capital is even more silent and passive than it was in the old system.

B. OWNERSHIP RESTRUCTURING AND CAPITAL MANAGEMENT

In Yugoslavia, privatization is often called "ownership restructuring," and it is being implemented according to the Federal Law on Social Capital. The existing or proposed laws on ownership restructuring in the Republics are similar to the Federal law (see Section IX.I below for a more detailed discussion of these laws).

The Federal Law offers several options for the privatization of social capital, but the stress is on the issuance of internal shares, i.e. a discounted sale of shares to workers and managers of enterprises on credit. It has been estimated that 1,200 social enterprises have already been partially privatized by the issuing of internal shares, while only 12 social enterprises were completely sold to the workers, managers, or other persons.[13] This method of privatization tends to introduce mixed ownership in Yugoslav enterprises in which capital is going to be partly in social and partly in private ownership. Thus the private owners are going to be predominantly internal investors who are going to control the enterprises even if they own only a minor portion of shares.

This type of mixed ownership will certainly impair the performance of enterprises and the economy as a whole. There are a number of reasons for this.

If privatization in Yugoslavia proceeds in the present way, ownership of enterprises would be completely dispersed among the workers and managers employed in them. The general public is unlikely to invest in

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[13] *Borba*, May 30, 1991.

enterprises controlled by workers and managers. However, the resulting internal ownership of enterprises is not essentially different from self-management, particularly in relation to problems with capital management.

In the former system, the government or the Party forced enterprises to accumulate and invest. This was done primarily through controls on income distribution and wages. Employees were primarily interested in increasing their earnings and consumption. The only constraint was that they were not free to invest in private enterprises and thus had some motive to reinvest revenues back into the socially-owned enterprises. Under the present conditions of a mixed economy, it is hard to forecast the behavior of the new owners (workers and managers) of enterprises.

In the case of an enterprise with mixed ownership, employees may be even less motivated to maximize the profits of the enterprise. It is much better for them to distribute as large a share of revenues as possible as wages/salaries and invest this in their own new private businesses. Their motivation to maximize salaries will be even greater since they can capture a portion of profit that would otherwise go to the residual social capital that has not been privatized.

In a mixed enterprise with dispersed employee ownership, no one would have effective control over it. The most influential controller would be the managers who may mismanage the enterprise for their own benefit. Faced with such an uncertainty, employees would probably find it in their best interest to decapitalize the enterprises as soon as possible. In doing so they would try to increase their wages to a point where the enterprises would make losses, so as to speed up decapitalization.

In fact, employee shareholders in a mixed enterprise will find themselves faced with two choices. One choice would be to maximize current wage earnings in cash, which might allow them to start their own business. The second choice would be to maximize the profit of the enterprise with the hope that they would acquire a stable future income from their ownership of the enterprise. Faced with the choices between certain current income in the form of high wages and uncertain future income in the form of dividends, employee-shareholders are likely to opt for the first choice.

The situation remains more or less unchanged even if we assume that the enterprises are going to be completely owned by internal investors, i.e. workers and managers as shareholders. In that case the management of enterprises is going to be similar to that of the old system of self-management, since all or almost all employees are going to be the owners and would have the right to participate in managing the enterprises.[14]

Another problem with the functioning of the mixed economy in Yugoslavia is the mobility of capital. In the former self-management system, it was the government that largely managed and planned the allocation of capital for new investments.

The weaknesses of the former system for allocating capital are well known. This is unlikely to improve if internal share ownership is to become the dominant feature of Yugoslav enterprises. In the market

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[14]The case of the Mondragon cooperative in Spain and ESOP schemes in the USA might be viewed as a counter argument to this conclusion. Though the Mondragon experiment is successful, it is an isolated island in the sea of traditional private enterprises in the Spanish economy. In addition, the Mondragon cooperative has not been duplicated elsewhere. Therefore, one can hardly imagine the functioning of an economy which would be entirely organized on the principles of the Mondragon cooperative. See Hinds (1990) for more details. As far as ESOP schemes are concerned, the commercial success of these ventures is mixed. Only in a very small number of US companies do employees own more than 50 percent of shares, but even then they rarely control these companies. Due to the wide-spread share ownership among employees, effective control over the management is usually in the hands of outside owners who are not employees. See Bradley and Gelb (1985).

economy, mobility of capital is a result of decisions by owners on whether to invest their profits in the same enterprise or in other economic sectors. They may decide to take away the profits from an enterprise and reinvest elsewhere. Such a decision can only be taken by an owner external to the enterprise whose fate is being decided.[15]

The most important reason that employee-shareholders are likely to have for investing revenues of an enterprise rather than paying higher wages is if they believe that such an investment will increase their job security. This almost guarantees that they will only favor investing in the enterprise in which they work.

There are two other reasons why internal owners (workers and managers) would tend to invest either in their own enterprise or in the same type of business. First, employee-shareholders in an enterprise would tend to invest in the same type of business since it is the one they know a lot about[16] The second reason concerns their readiness and motivation to devote the time and effort to monitor the investment. The share of each employee's ownership in each new investment would be small. If they invest outside of their current firm or business activity, they have to devote a lot of time and effort to monitor those investments. This again means that they are likely to invest either in their own enterprise or in the same type of business.

The present mixed economy in Yugoslavia has another major drawback. Outside investors are wary of investing in enterprises that are controlled by employees. Such enterprises, as explained above, will be inclined to behave in a way similar to the "self-managed" enterprises under the old system. Unless it is certain that such mixed enterprises would maximize profits, outside investors will not tend to invest in them. One of the main objectives of the market oriented reform in Yugoslavia is its integration into the European and global economy. The mixed economy model is not suitable for reaching this goal.

C. MANAGEMENT OF ENTERPRISES

The Yugoslav mixed economy will face serious problems in managing enterprises and controlling the managers. The new system is similar to the old one, but the controlling mechanism of the old system is almost completely removed.

If the enterprises in the mixed economy are to be totally controlled by inside owners (workers and managers), even though they might own only a small part of the capital, it is difficult to see how corporate governance is to be introduced. In fact both, before and after ownership transformation (privatization), the same employees are entitled to manage the enterprises. Internal employee ownership as the method of ownership transformation in Yugoslavia is based on the expectation that internal owners would have a strong interest to protect their own capital and would also care about the residual social capital left in a mixed enterprise. As explained above, such expectations are unjustified. Even if some form of corporate governance is introduced in Yugoslav mixed enterprises, one could hardly suppose that it could be substantially different from what existed under self-management.

This problem is further aggravated by the fact that the position of managers in Yugoslav mixed enterprises is ill-defined. It is difficult to see who they are going to represent and whose interest they should protect. Furthermore, it is not clear who is going to control the managers in mixed enterprises.

In Western economies the managers of enterprises represent the interests of owners. The owners are clearly defined. They appoint the board of directors, which has a legal right to control the managers and monitor the performance of an enterprise on behalf of the owners. In the old system of self-management, the managers represented an unknown owner but have been subject to an elaborate system of internal and

[15] Hinds (1990).

[16] Hinds (1990).

external control and monitoring. Internal control was exercised by self-management bodies of enterprises. External control has been exercised by the government (party) directly through the Social Accounting Authority and indirectly by controlling who can be selected as general manager.

This problem of reduced control over the managers is compounded by the fact that private enterprises can now be established to compete with socially-owned enterprises. This creates an incentive for managers and skilled workers of socially-owned enterprises to leave and establish their own private businesses. The risk is that these managers and workers will also take the assets (both real and intellectual) of the socially-owned enterprises with them since there are no owners to protect these assets.

For example, socially-owned enterprises could enter into contracts with private firms owned by the managers on terms highly favorable to the private firms. Another possibility is that managers may agree to one-sided joint ventures between the socially-owned enterprises and private firms. The socially-owned enterprise agrees to contribute a disproportionately large share of the assets into the joint venture thus enriching the private firm. The private firm can reward the managers of the socially-owned enterprise for their agreement in a variety of ways.

This has sometimes been called "self privatization" or "spontaneous privatization" because the managers plan and carry out the sale of the enterprise assets rather than the government. In blunt terms, this could also be called privatization through theft. The smart managers will find ways to appropriate the social capital for themselves leaving little for the rest of the citizens.

In conclusion, the experiment with a mixed economy in Yugoslavia should be stopped so as not to jeopardize its future development outlook. Instead, rapid ownership restructuring is desirable. Its main aim should be to introduce better corporate governance in privatized enterprises.

Unless this is done, there is serious danger from spontaneous privatization of social capital. This could have not only negative socio-political consequences but could endanger the country's future development prospects. Namely, if spontaneous privatization occurs, one may expect that a considerable share of the privatized capital would be channelled abroad. Experiences of Latin American countries suggest this possibility.

Based on this analysis of the current economic situation, a choice must be made between either:

1 quickly restructuring ownership (probably within a year) so that the new owners can take control of the enterprises and assure that the managers and workers do not appropriate the assets; or

2 establishing an interim system to control the managers of the enterprises until new owners are given control.

VI. CRITERIA FOR JUDGING OPTIONS

The main goal of privatization in Yugoslavia is to increase the efficiency of each enterprise and thus the economy as a whole. Because of the bad experience with self-management, the enterprises should be privatized in such a way that they will be governed and controlled like traditional corporations in Western economies.

Privatization should be designed to immediately create a stable core of ownership for each large enterprise. Widespread share ownership by thousands of small owners will do little to improve corporate governance. This is particularly true since it is unlikely that a capital market in Yugoslavia will be developed in a short period of time that would allow shares to be easily sold. Even if shares can be sold, there is no guarantee that a single owner or ownership group with a controlling block of shares in each enterprise would emerge in the near future. Such a core owner has to be created through the privatization process. The country should avoid creating dispersed or atomized ownership if effective corporate governance is to be introduced in large enterprises.

Privatization or ownership restructuring of the Yugoslav economy needs to be done quickly. Speed should be the next major objective of a privatization program in Yugoslavia. Slow privatization will tend to aggravate the already grave economic crisis in the country. Privatization is necessary to improve managerial efficiency and enterprise productivity and thus the performance of the overall economy. But it will take years before the full benefits of private ownership will be felt. If privatization itself is going to be a slow process, efficiency gains could be delayed for years if not decades.

The third main privatization objective in Yugoslavia should be fairness. That is to say, social capital needs to be privatized in the way which the society finds to be fair and equitable. Social capital is legally defined to belong equally to all members of the society. If social capital is to be privatized, no member of society should be deprived of his or her rights to own social capital or to benefit from the sale of that capital.

The above analysis suggests that three criteria should be used to evaluate any particular option for ownership restructuring:

1 how much will the option improve corporate governance and thus economic efficiency;

2 is the distribution of the wealth resulting from transferring ownership to private individuals considered to be fair; and

3 can the option or proposal be implemented quickly?

The balance of this report will be devoted to analyzing the various options to determine how they rank against these three criteria.

In addition to these three criteria, it is important to assess whether an option has any major fiscal or macro-economic impacts on the overall economy. All of the options transfer large sums of capital, wealth, or money from one group of citizens or institutions such as the government, other citizens, or institutions to another group. This may have major impacts on revenues to the government, tax levels, and consumption expenditures by citizens. In turn it may impact inflation, savings, investment, growth, and other important aspects of the economy. In some cases, the impact may be desirable; in others, undesirable.

VII. RESTRUCTURING OF INDUSTRIES AND ENTERPRISES

Before analyzing particular options for ownership restructuring, it is useful to discuss economic restructuring in general. The term "restructuring" has come to mean a wide variety of reforms necessary to transform Yugoslavia into a Western-style economy and to modernize all enterprises and institutions. Ownership restructuring is just one of many related reforms that are needed. Without discussing all of these reforms, three types of restructuring in addition to ownership restructuring need to be discussed. These are:

1 <u>operational</u> restructuring of individual enterprises and entire industries to improve efficiency and profitability;

2 <u>competitive</u> restructuring to eliminate monopolies and enhance competition; and

3 <u>financial</u> restructuring to restore financial solvency of potentially profitable enterprises and the banking system.

A key issue is whether the government should undertake these types of restructuring prior to ownership restructuring or should such restructuring be left to the new owners of the enterprises.

A. OPERATIONAL RESTRUCTURING

In Yugoslavia, restructuring often means a government led program to improve and modernize the operations of enterprises and entire industries. This results from the recognition that Yugoslav enterprises lag behind enterprises in Western countries in manufacturing techniques, equipment, facilities, management, accounting, financial controls, and so forth. Perhaps the most needed restructuring is to reduce the size of the work force in many enterprises.

The structure of entire industries has also been distorted and made less efficient by past government policies which have encouraged the development of large conglomerate enterprises with operations in many unrelated businesses. The operations of these enterprises might be made more efficient by breaking them up into smaller enterprises.

Other industries, however, have too many independent enterprises with each being too small for efficient operation. This has sometimes resulted from the desire by each Republic to have a particular industry such as steel located in that Republic. The result may be six small enterprises in an industry which would be more efficient with just one or two larger enterprises. Consolidation would lower costs and increase profitability.

Government programs to restructure enterprises and industries are the exception rather than the rule in the more developed Western countries. This is not because enterprises and industries are so efficient that restructuring is not needed. Enterprises and industries in all countries often need to be restructured. Such restructuring, however, is largely the responsibility of the private owners of enterprises. Since they own the enterprises, it is assumed that they have both the expertise and the incentive to modernize and improve the operations of the enterprises.

Similarly, the restructuring of an entire industry is usually the responsibility of the owners of the enterprises in that industry. If an enterprise would be more efficient by being split up into smaller enterprises, the owners have an incentive to carry this out. Thus such terms as "divestment" and "spin off" are commonly used to describe when part of an enterprise is separated and sold to another enterprise or set up as an independent enterprise. Similarly, if efficiency would be increased by consolidating enterprises into larger enterprises, the owners of the enterprises arrange "mergers" and "takeovers." Industries are constantly undergoing this kind of restructuring.

The dilemma for Yugoslavia is whether operational restructuring should be carried out by the government or left to new owners after ownership restructuring. In other words, should operational restructuring occur before or after ownership restructuring?

The major argument for a government led program of operational restructuring is that ownership restructuring may take a long time to carry out. Because of the poor state of the economy, operational restructuring cannot wait for ownership restructuring. The government must make improvements now. Until new owners are in place, the government must take responsibility.

The major argument against a government led program is that neither the government nor the current management of these enterprises has the necessary expertise, incentives, or the money to carry out such a restructuring. It was past misguided government policies and poor management of the enterprises that created the current inefficiencies and poor structure. Why should it be expected that the government or current management now have the ability or the incentives to carry out a restructuring?

The worst possible outcome is that a great deal of money may be spent on restructuring that is largely wasted, for example, if it is spent on maintaining high worker incomes instead of modernizing the enterprise. As long as the enterprises are under the control of existing management and workers, this is certainly a possibility.

This dilemma would be resolved by fast ownership restructuring. New owners would have the proper incentives to carry out restructuring and would be able to manage the process. This is not to say that a government program to assist enterprises in restructuring would not be useful. A properly designed program could assist the new owners in carrying out restructuring. For example, the government could obtain funds for new investment from such international agencies as the World Bank or the European Bank for Reconstruction and Development and channel these funds to private enterprises that have a sound program for restructuring.

B. COMPETITIVE RESTRUCTURING

A special issue concerning restructuring is whether some industries are dominated by monopolies, and thus a government program to create competition is necessary. In some cases, past government policies have created large enterprises that are the only producer or seller of particular products. If transferred to private owners, these enterprises may be able to charge high prices and earn excessive profits.

This is one case where private owners would not have an incentive to carry out restructuring. The private owners would not voluntarily break up a large monopoly since doing so would increase competition and thus reduce prices and profits.

Unfortunately, the available data on the number and size of enterprises in particular industries is not helpful in determining whether a competition problem exists. To determine the degree of competition, one needs to know how many independent enterprises are producing a specific product. Since about 1974, the Social Accounting Service has collected data concerning only the "Basic Organizations of Associated Labor" (BOAL). In some cases, a BOAL can be thought of as an independent enterprise. In other cases, however, a BOAL is more like a division or a subsidiary of a larger enterprise and is not an independent entity. Thus the official data may show many BOALs producing a single product, but yet they all may be divisions of a single enterprise that has substantial monopoly power.

If most BOALs are independent, only a few industries appear to lack competition. (Annex E provides data on the size distribution of BOALs in about 60 industries.) Only in the energy, mining, and metals sectors of the economy does it appear that a few large BOALs dominate each industry. Even if BOALs are independent, however, this does not rule out the possibility that a monopoly problem may exist in smaller sub-industries or within particular regions of the country. Data on the size structure of enterprises prior to 1974 suggests that many industries were dominated by a few large enterprises,[17] but it is unclear how the structure of industries has changed since then.

Even if just a few Yugoslav enterprises account for most of the sales and production in a particular industry, monopoly may not be a serious problem for two reasons. First, domestic Yugoslav companies have to compete with foreign firms selling the same product or service. If a Yugoslav company is charging a high price, there is an incentive to import that product. The price of an imported product may be increased due to tariff duties, but this price still is a limit on how much the domestic firm may charge.

The second reason is the ability of new enterprises to start up and begin producing the product or service. This is particularly true now that private enterprises and foreign firms are permitted to operate in Yugoslavia. If an existing socially-owned enterprise is charging high prices, it runs the risk that a private firm or a

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[17]Estrin (1983).

foreign firm may begin to produce the product. This "threat of entry" by new firms may be as effective in limiting prices as would be the case if many firms are now producing the product.

The most serious competition problems and monopolies are those created by governments through their power to pass laws and regulate the economy. There is considerable pressure for Republic governments to protect their own enterprises against competition from "foreign" enterprises, namely, enterprises located in another Yugoslav Republic. The concern is that competition from enterprises in other Republics will reduce profits and cause unemployment. Thus barriers to trade between Republics are a growing problem in Yugoslavia.

These Republic policies that discourage competition are harmful since local enterprises then have little or no incentive to become efficient. Instead they charge high prices and in effect levy a tax on the citizens of the Republic to support their inefficient operations.

Competition from foreign firms (including those in other Republics as well as in other countries) should be effective in limiting monopoly power by the existing firms in a particular industry. If, however, each Republic attempts to limit competition from enterprises in other Republics or other countries, it is quite possible that the industries in each Republic will be dominated by a few enterprises with substantial monopoly power. Such monopoly power fostered by the Republic governments has two bad effects -- consumers have to pay higher prices and the enterprises have little incentive to become efficient. The solution to this problem may not be to engage in the expensive and difficult task of restructuring industries to increase competition but for the Republic governments to alter their policies restricting competition.

C. FINANCIAL RESTRUCTURING

Many if not most enterprises in Yugoslavia are in financial difficulty. The most important cause is the current economic depression or crisis in Yugoslavia. Though most Eastern European countries are experiencing economic difficulties, the situation in Yugoslavia is made much worse by the political uncertainty and the civil war. If the current economic crisis were to be resolved and production and incomes returned to more normal levels, the financial problems of many enterprises would disappear. In other words, the financial difficulty of many enterprises is a short-run problem that will be resolved when the economy improves. Other enterprises, however, are likely to be financially insolvent in the long-run even if the economy improves.

With regard to these latter enterprises, the two most important causes of long-run financial insolvency are an excessive number of workers and large outstanding debts primarily in the form of bank loans. These two causes are often interrelated. Some enterprises have borrowed excessively to pay the wages of their excessively large work force.[18] The problem of surplus workers should be solved as part of operational restructuring while the problem of financial insolvency should be resolved as part of a financial restructuring program. The issue is whether this financial restructuring should be carried out by the government prior to ownership restructuring, by the new owners, or in some other way.

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[18]Enterprises also owe substantial amounts of money to each other. Thus enterprises have large outstanding "accounts payable" and "accounts receivable." Refusing to pay debts owed to other enterprises is one way for an enterprise to deal with the current liquidity crisis. These debts, however, largely net out when the enterprise sector as a whole is considered. What is a debt for one enterprise is an asset for another. On occasion, the Social Accounting Service has organized a balancing out of these various debts. This process is referred to as "multilateral compensation." The end result is that accounts receivable and payable are substantially reduced. Thus in this analysis of financial restructuring of enterprises, we have ignored the large amounts of accounts payable and receivable in the enterprise sector.

This insolvency of some enterprises has also caused the majority of banks to be insolvent since the enterprises cannot repay the loans made by the banks. Thus financial restructuring of enterprises must involve the restructuring or rehabilitation of banks as well.

Financial restructuring would require placing all enterprises into three categories:

1 enterprises that are financially solvent and can repay their debts;

2 enterprises that should be shut down and liquidated. Their assets or property should be sold and the proceeds used to repay at least some of their debts. These enterprises are unlikely to be profitable even if all of their debt was eliminated; and

3 enterprises that could again be profitable if their outstanding debts and thus interest payments were reduced or scaled down. These enterprises are basically sound but are hampered by excessive debts. They should be allowed to continue to operate because they are worth more as an ongoing business than if they were liquidated and their assets sold. For such enterprises to continue in operation, the lenders will have to accept a reduction or scaling down of their loans since the enterprises cannot repay all of their loans.

This categorization will also determine the true financial situation of the banks since it will then be clear which bank loans to the enterprises can be repaid and which are "bad" loans that can never be repaid. Because the government guarantees bank deposits, the government will have to step in and provide additional assets to the banks to make up for the bad loans. For example, the government could replace the bad bank loans with government bonds. The end result, however, is that the government will have to raise the money necessary to restore the banks to solvency. Ultimately, most of the bad loans of the enterprises will become the responsibility of the government in one way or another.

Financial restructuring could be lengthy and complicated because of the large number of enterprises involved. A detailed examination of the current and likely future operations of every enterprise would have to be carried out by a team of experts. The question is how can this be done in a practical way that does not indefinitely delay ownership restructuring.

Three main options exist for financial restructuring of both enterprises and the banks. The first is for the government to carry out this restructuring prior to any ownership restructuring. Two institutions have already been created that may be able to carry out this large task: (i) the restructuring agencies that have been established in each Republic and (ii) the Federal agency for bank rehabilitation. The end result would be the liquidation of enterprises in the second category described above, a scaling down of the debts of the enterprises in the third category, and an estimate of the total bad debts of the banking system. The government would then have to provide the necessary assets to the banks to restore them to solvency.

Following this financial restructuring, those enterprises that were not liquidated could be sold or transferred to new owners. Because of the scaling down of debts, all enterprises transferred to new owners would be solvent and profitable.

The second option for financial restructuring is a large scale "debt-equity swap." For those enterprises that cannot repay all of their debts, the lenders (primarily banks) would simply take over ownership in proportion to their loans to the enterprises. All debt of these enterprises would be eliminated, and the lenders (the banks) would become the owners. In other words, banks would exchange their debt for equity. The new owners can then further decide which enterprises should be shut down (liquidated) and which should continue in operation. A debt-equity swap would result in both the financial and ownership restructuring of these enterprises. Note that this second option does not resolve the financial problems of the banks. The government would still have to provide assets to the banks to make up for the bad bank loans.

In this case, the banks are likely to become owners of a significant proportion of enterprises in Yugoslavia, namely those enterprises in the second and third categories discussed above. The enterprises in the first category which are financially solvent could then be transferred to new owners following one or more of the options for ownership restructuring analyzed in this report.

The third option is to undertake financial restructuring after ownership restructuring. This option creates a number of problems because private individuals or institutions would have little interest in owning insolvent enterprises in the second and third categories discussed above. Because of their large debts, these enterprises are worthless to new owners.

Even if private individuals or institutions could be induced to take over ownership, the end result is that most of these enterprises would simply be declared bankrupt and transferred to the jurisdiction of bankruptcy courts. A bankruptcy court protects the interests of the lenders or creditors of an enterprise that cannot repay all of its debts. The bankruptcy court would then have to decide whether an enterprise should be liquidated or whether it can continue in operation if its debts are reduced. Under this option, the bankruptcy courts would have primary responsibility for financial restructuring. Also note that the government would still have to restructure the banking system under this option and provide the necessary assets to restore the solvency of the banks.

This issue of financial restructuring is complex, and it has not been possible to analyze it in sufficient detail to make firm conclusions about the best option. Our tentative conclusion, however, is that a debt-equity swap has considerable merit. It could be done quickly. The ownership of any insolvent enterprise would simply be transferred to the banks that have lent it money. The banks would have a strong incentive to restructure these enterprises and attempt to make them profitable. In this way, the banks would be able to recover some of the money that had been lent to the enterprises. Such bank ownership of enterprises would follow the pattern in Germany and Japan.

VIII. GOVERNMENT OWNERSHIP

The first of the four ownership restructuring options to be analyzed in this report is for the Federal or Republic governments to take over the ownership of enterprises. According to official estimates, 40 percent of the socially-owned capital in Croatia and 25 percent in Serbia will be nationalized or transferred to Republic ownership including railways, roads, utilities, postal service, telephones, electricity, and the oil industry (see Annex H). The other Republics are also following this example to a greater or lesser extent. Their draft laws on ownership restructuring often specify a long list of industries of "exceptional public interest" that would be kept in government ownership.

When transferred to Republic ownership, the Republic governments can exercise the rights of an owner including taking the profits of the enterprise and appointing the boards of directors and the managers of the enterprise. What is not clear is whether the Republics intend this form of ownership to be permanent or only temporary until these enterprises can be transferred to private ownership.

A. EFFICIENCY OF GOVERNMENT-OWNED ENTERPRISES

Many Western countries also have corporations owned by the government. In contrast to Yugoslavia, the trend in Western countries is away from government-owned enterprises (GOEs) in favor of enterprises owned by the private sector. A widespread view in many countries is that GOEs are less efficient than privately-owned enterprises which has caused many governments to privatize their GOEs.

Evidence from other countries suggests that GOEs are less efficient than enterprises owned by private investors for three reasons:[19]

1 political interference. A common problem is that politicians direct the activities of GOEs to achieve political objectives rather than economic objectives such as providing employment to members of the party in power.

2 mix of social and economic objectives. Even if politicians do not use GOEs to pursue political objectives, most governments believe that GOEs should be used to achieve legitimate social objectives as well as economic objectives. Such social objectives might include keeping prices low for low income consumers, providing cheap housing or free medical care, maintaining high levels of employment, training workers, investing in underdeveloped regions of the country, and so forth. A private firm would not voluntarily undertake these activities because they would reduce profits. The poor performance of the GOEs is largely due to the fact they are asked to pursue a confused mix of social and economic objectives. This mix of goals makes it impossible for the owner (the government) to evaluate the performance of the enterprise.

3 lack of competition. Governments tend to protect their GOEs from competition. Competition is one of the most important incentives for efficiency by an enterprise whether private or government owned. Because competition reduces profits and thus revenues to the owner (the government), the government has a strong incentive to limit competition using its legal powers. For example, GOEs are often monopolies because the government prohibits private firms from selling products or services in competition with the GOE.

B. FISCAL AND MACROECONOMIC IMPACTS

One argument for government ownership is that the government as owner can collect the profits of the enterprise. This source of revenue can substitute for tax revenue. On the one hand, this source of government revenue could be beneficial to the economy. As a consequence, the general level of government taxes could be lower than what would otherwise be the case. There is considerable evidence that high tax levels cause distortions and reduce overall productivity in an economy and thus income levels.

On the other hand, GOEs are notoriously inefficient and large loss makers in many countries. Government revenues would often be higher by taxing the profits of privately-owned enterprises instead of receiving all of the profits of government-owned enterprises.

C. THE SPECIAL CASE OF NATURAL MONOPOLIES

The evidence in Western countries suggests that there is only one type of enterprise where ownership by the government may be as efficient as ownership by the private sector. These industries are those where a natural monopoly exists.[20] Because of the technology of production in these industries, it is less costly for just one enterprise to produce a particular product or service. These "natural monopolies" include electric power, telephones, water supply, etc. The importance of natural monopolies is being reduced as new technologies create alternative ways of providing the same or alternative services.

Because it is not efficient to have more than one enterprise supplying these services, a monopoly is likely to result. If this monopoly is privately owned, it may charge excessively high prices. In some countries, this problem is solved by having the government own the enterprises. In other countries, the enterprise is pri-

[19]For example, see: Vickers and Yarrow (1988), Yarrow (1986), and Carson (1990).

[20]See Vickers and Yarrow (1988).

vately-owned, but its prices are regulated by the government. The evidence suggests that the performance of a regulated private monopoly is about the same as a government-owned monopoly. Thus it probably makes little difference whether Yugoslavia chooses to have the government own these industries or to transfer them to private ownership and then establish an agency to regulate their prices.

Arguments are sometimes given for government ownership of other industries besides natural monopolies. For example, the industry is exceptionally large and important, a "basic" industry, an "infant industry" in need of government support and protection, or a so called "infrastructure" industry. Evidence from Western countries suggests that such industries if government-owned rarely perform as well as private enterprises and often perform much worse. For Yugoslavia to adopt an economic system where government ownership is dominant would be in effect to adopt the economic system that Western and other Eastern European countries are rejecting.

D. CORPORATE GOVERNANCE

For those enterprises which are retained in government ownership in Yugoslavia, the government needs to establish a system of corporate governance. Like any owner of a corporation, the government will need to appoint a board of directors to monitor and oversee the enterprise and receive periodic financial statements showing the performance of the enterprise. In order for these enterprises to be as efficient as possible, the government must be an "active" owner.

Because of the poor performance of GOEs, attempts have been made to improve their corporate governance in many countries. Based on a review of this experience in other countries, we believe that a system of corporate governance for GOEs in Yugoslavia should have the following features:[21]

- each GOE should be established as a joint stock company with the government owning all of the shares;

- the government should appoint only experienced businessmen to the board of directors. The appointment of government officials or politicians will only introduce undesirable political or social considerations in the management of the enterprise;

- the clear, legal objective of a GOE should be for it to be as profitable as possible. In other words, it should have the same objective as a privately-owned firm.[22] The enterprise should not be given social or political objectives;

- the GOE should be required to announce targets for improving its performance at the beginning of each year;

- the GOE should publish detailed financial and accounting statements so that the government and all citizens can judge its performance in general and whether it has achieved its targets; and

- if the government should require the GOE to pursue a social or political objective that would increase its costs or reduce its revenues, then the government should compensate the enterprise for the reduction in profitability.

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[21]See Anderson (1990).

[22]A natural monopoly owned by the government is a special case. Because it is a monopoly, such an enterprise should not be permitted to maximize profits by charging very high prices. Even though it is government owned, a special independent regulatory agency should be created to regulate the prices charged by such an enterprise.

Both Italy and New Zealand have adopted this last feature for their system of managing GOEs. If these governments require a GOE to do something that would reduce its profits (for example, reduce prices to certain customers or hire more workers than are needed for efficient operation), the government must pay the enterprise to compensate it for the loss of profits. In this way, the cost of the government's requirement is calculated and made public. Nothing is hidden.

Though transfer of socially-owned enterprises to government ownership will probably do little to improve corporate governance, it would be considered fair and equitable. The government would receive any profits earned by such enterprises, and thus all citizens would benefit. Such a transfer of ownership could also be done quickly since it would simply require an act of parliament nationalizing the enterprises.

In conclusion, government ownership may be little better than social ownership and self-management and is likely to be worse than private ownership. Only for a limited number of "natural monopolies" can a case be made that the government should own enterprises.

IX. SALE OF SOCIALLY-OWNED ENTERPRISES

When most people think of privatization or ownership restructuring, they often assume that this will be carried out by selling the enterprise to private individuals. This is the most common method of privatization in Western countries and is also the method specified in the Federal Law on Social Capital and in most of the proposed Republic laws.

A. FEATURES OF A SALE PROGRAM

In designing a sale program, a number of questions need to be answered:

- who are the likely buyers of the thousands of enterprises to be sold?
- will the sale price be the "fair market value" or will discounts be given to certain classes of buyers?[23]
- will the sale be carried out quickly or will it take a long time to complete?
- who is to receive the proceeds of the sale?
- where is the large sum of money to purchase the socially-owned capital likely to come from?
- what will the sale proceeds be used for by whoever receives them?

B. SALE PROGRAMS IN WESTERN COUNTRIES

Many Western countries have recently sold many enterprises owned by the government. (Annex F describes this experience). The basic objective of privatization in most Western countries was to improve corporate

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[23] "Fair market value" is that price which reflects the future profits of the enterprise. Determining "fair market value" is difficult since the future profitability of the enterprise must be estimated. The current economic and political situation in Yugoslavia makes the future profitability of an enterprise extremely uncertain. In technical terms, "fair market value" of an enterprise can be best estimated by the present value (discounted) of the future net cash flow of the enterprise. Cash flow in the very distant future is worth less than cash flow in the near future. Calculating present discounted value is a recognized technique for converting cash flows at various times in the future into a single value that can be compared with other investments.

governance, thus resulting in more efficient and profitable enterprises, higher incomes, and faster economic growth.

Other objectives announced by Western countries for their privatization programs, however, are quite different from improving corporate governance. These included employee share ownership or widespread share ownership by the general public. When the experience of Western countries is examined more closely, the privatization programs were not very successful in achieving these other objectives.

Though discounts were offered to workers in Great Britain, for example, employee purchases usually did not exceed five percent of the shares. In the United States where employee share holding is more widespread, it is rare for employees to own a significant proportion of shares in larger companies and even rarer for employees to own more than half of the shares.

An important objective of privatization in Western countries was that the process of privatization should be fair and equitable to all citizens. By selling to the highest bidder, the government received the fair market value of the enterprise, and thus all citizens benefitted from the sale. If any group was allowed to purchase these assets at below fair market value, then it can be said that this group benefitted at the expense of the rest of the citizens.

An important difference between the experience in Western countries and in Yugoslavia is the much larger size of the program required in Yugoslavia. For example, Great Britain had one of the best known privatization programs but only privatized about 60 enterprises over a period of 12 years or about five enterprises per year. This is much too slow for Yugoslavia by any standard where thousands of enterprises would need to be sold. Thus in conclusion, the main objective of privatization in Yugoslavia should be similar to the privatization programs in Western countries, mainly to improve corporate governance; but the techniques of privatization may have to be very different.

C. SALE TO FOREIGN INVESTORS

There is probably little disagreement that a sale of Yugoslav enterprises to foreign investors would be highly desirable if the sale price represented fair market value. Such a sale would have a number of important advantages:

- foreign capital would be invested in the country. This supplements domestic savings and contributes to faster economic growth;
- foreign buyers would probably bring in modern Western technologies and new business management techniques; and
- foreign buyers may have greater access to foreign markets and thus can export more Yugoslav products.

One argument against such a sale is that foreign owners may not manage a Yugoslav enterprise in the best interest of the Yugoslav society. More realistically, both a foreign owner and a private domestic owner are likely to have the same objectives and motives in managing the company, namely to maximize profits and increase the value of the owner's investment. The only difference is that a foreign owner may be better able to manage the enterprise and increase its efficiency and profitability.

The one serious problem that is likely to occur with a foreign sale is if the sale price is below fair market value. In such a case, the foreign buyer unfairly benefits and Yugoslavia is penalized. Part of the social capital would be given away to foreign citizens to the detriment of Yugoslav citizens. Thus with any sale to foreign investors, it is important to accurately value the assets of the enterprise to make certain that Yugoslavia is being treated fairly.

Unfortunately, a rapid sale program is unlikely to obtain fair market value. Because of the current economic and political uncertainty in Yugoslavia, foreign investors will reduce their estimate of the value of an enterprise to reflect this greater risk. Now is probably the worst possible time to attempt to sell enterprises to foreign investors. This problem is not just due to the current political situation. Even if the political disagreements were resolved, foreign investors realize that Yugoslavia is undergoing an economic revolution with the legal framework and almost every institution being reformed. Until this new system has been in operation for some years, investors will be cautious about investing in a new, untried economy with which they have little experience.

Another drawback to a large, rapid sale of enterprises to foreign investors is the administrative cost. Selling an enterprise requires substantial effort by skilled accountants and financial experts. The only comparable experience is the program to sell former government-owned enterprises in eastern Germany to investors from both western Germany and other countries. The German holding company responsible for sale, Treuhandanstalt, has a staff of 2,500 people.[24] Treuhandanstalt was able to draw on the large pool of experts in Western principles of accounting, finance, and management that existed in the western part of Germany. In Yugoslavia, few individuals have such training. In particular, the sales process will require that the assets of each enterprise be valued so that the government can be assured that foreign owners are paying fair market value. Given the uncertain economic and political situation in Yugoslavia, such valuations are difficult and open to considerable dispute about their accuracy.

D. SALE TO YUGOSLAV CITIZENS

Though sale to foreign investors should not be ruled out in the longer term especially if the political situation should improve, the only realistic sale option in the near future is to sell Yugoslav enterprises to Yugoslav citizens. Selling enterprises to Yugoslav citizens raises at least three important questions.

1 will a rapid sale be fair?

2 will a rapid sale improve corporate governance? and

3 will sale to Yugoslav citizens deprive enterprises of the funds they need to modernize and expand?

E. FAIRNESS OF A RAPID SALE PROGRAM

There is likely to be a trade-off between speed and fairness in a sale program. As indicated above, ownership restructuring should occur rapidly. If a massive sale program is undertaken quickly, however, this is likely to result in a minority of citizens buying the social capital at low prices relative to fair market value.

Sale at low prices would be necessary because of the lack of financial assets in the hands of citizens that can be used to buy the social capital. Admittedly any estimates of either the value of social capital or the financial assets held by citizens are uncertain. Using the estimate discussed above of the value of the social capital ($60-130 billion), where will private citizens obtain the necessary funds to buy this capital?

Existing bank deposits (both foreign exchange and dinar deposits) held by households amount to only about $12 billion (see Annex C). Another source is new savings of households, in other words, that portion of annual income that is not spent for consumption. Household savings are estimated to be roughly $5 billion per year (see Annex C) based on 1989 data. Even if all existing bank deposits and all new household savings each year were used to buy shares in socially-owned enterprises, the privatization process would take from 10 to 20 years to complete.

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[24] Pohl (1991).

Even this estimate is optimistic because of the decline in economic activity and thus savings since 1989. Since a rapid deterioration of economic activity has taken place and is likely to continue, this estimate of future savings needs to be reduced to reflect the change in the economy since 1989. Precise estimates of future savings that reflect the decline in economic activity do not exist. But given the large decline in economic activity, it is reasonable to expect that the household sector will not be able to save very much in the next few years. Certainly the share of household savings in GDP will be much less than the level of 8.2 percent which occurred in 1989.

Furthermore, there is no clear indication of what has happened to the bank deposits held by households in 1991. At the end of 1990 they amounted to $12 billion. According to some preliminary information, it is very likely that they are going to decline by at least $3 billion in 1991. As a result of war and severe economic problems facing the country, it is realistic to predict that household deposits are going to be further reduced in 1992. In addition, it is also realistic to assume that those deposits are not going to be available in 1992 and next few years for buying shares in socially-owned enterprises.

Thus in conclusion, the sale of social capital at its fair market value could take decades to complete. By any standard, privatization based on sale to Yugoslav citizens would take far too long.

Another possibility is that citizens may save more to purchase shares. In other words, they might find the prospect of buying shares so attractive that they would reduce consumption and use more of their income to buy shares. For this to be likely, the shares would have to be very attractive investments, i.e., the shares would have to be sold at a low price relative to their fair market value.

Another possible source of funds are deposits held by Yugoslav citizens in foreign banks. These deposits were accumulated over the years by Yugoslav workers in Germany and other Western European countries and by citizens taking money out of the country to avoid inflation. No one knows how large these deposits are, but they may be substantial.

Even if these deposits are large, is it realistic to expect that Yugoslav citizens would bring them back to Yugoslavia to purchase shares in enterprises being sold? Like foreign investors, Yugoslav citizens will be deterred by the current political and economic uncertainties. Even if they were willing to invest in Yugoslavia, they are much more likely to be attracted to new smaller enterprises in the private sector. Here a Yugoslav citizen can be the majority owner and thus control the enterprise rather than be just one of thousands of investors in a large enterprise from the social sector.

If a rapid sale of many enterprises is attempted, the only practical approach is to sell the shares at low discounted prices. The available financial assets might then be adequate to buy the shares in a short period of time. Also low priced shares may cause Yugoslav citizens to bring back deposits held in foreign accounts or to reduce consumption in order to buy more shares. There is a direct trade-off between speed and price. The lower the price of the shares, the shorter would be the period required to sell the shares.

Selling the social capital at low prices, however, is unfair to many citizens. Since the existing financial assets of citizens is unequally distributed, some citizens are going to be in a much more favorable position to buy shares than others. It is realistic to expect that only a minority of citizens are likely to be large purchasers of shares.

The consequence is that this minority of citizens would become even richer because they would have the opportunity to buy shares at a large discount. The distribution of income and wealth in Yugoslavia could become much more unequal after a rapid sale of shares at low prices.

F. IMPROVEMENT IN CORPORATE GOVERNANCE

The fast sale of shares may also do little to improve corporate governance at least for some years. The reason is that the ownership of shares is likely to be widely dispersed. As a result no single owner or group of owners will exercise control over the operation of an enterprise.

In order to sell a large amount of shares, they would have to be purchased by many smaller investors. Yugoslavia does not have many wealthy individuals, large private corporations, or financial institutions that could purchase large blocks of shares. The end result is that an enterprise is likely to have thousands of owners each owning a small proportion of the shares.

In the sale of government-owned enterprises in Western countries, the purchaser was often a private corporation in the same line of business. This private corporation had a strategy for managing the enterprise and the experience and skills to carry out this strategy. In the French privatization program, for example, emphasis was placed on finding a "stable core" investor who had the ability to improve the operations of the former government-owned enterprise (see Annex F for more details.)

In contrast, the corporate governance of a Yugoslav company that is sold to thousands of small investors is likely to be little improved over the situation today. Because no owner has an incentive or the ability to oversee and monitor the management of the business, the enterprise will be controlled by the professional managers. Eventually, as the Yugoslav economy becomes more sophisticated and financial institutions develop, the ownership of a company may become more concentrated in the hands of a few owners who would take a more active interest in the enterprise. This, however, is not likely to occur quickly.

G. FISCAL AND MACROECONOMIC IMPACT

Regardless of whether the sale is carried out quickly or slowly, the huge size of the sale relative to the economy could seriously reduce new investment and thus economic growth. In order to avoid this, it is necessary to find some way of "recycling" the proceeds of the sale back to the private sector.

To understand this concern about "recycling", it is important to realize that most funds used to purchase shares in an enterprise have probably been diverted from some other productive investment. For example, assume that an individual decided to withdraw a bank deposit and use the funds to buy shares in an enterprise. The bank would then have fewer funds to lend to enterprises for modernization and growth.

Alternatively, suppose that an individual was planning to invest some of his or her savings in a new private company. Instead he or she decides to buy the shares in a socially-owned enterprise being offered for sale by the government. The private sector is then deprived of the capital needed for modernization and growth.

It is conceivable that a large sale of shares might raise "new" capital for the Yugoslav economy rather than simply redirecting existing capital. Such new capital could come from three sources:

- sale of shares to foreign investors;
- Yugoslav citizens bringing back to Yugoslavia deposits held in foreign banks; and
- Yugoslav citizens reducing their consumption and saving more of their income.

Though one can not be certain, new capital from these three sources is likely to be small, and the bulk of the proceeds received through sale is likely to be "old" capital. Thus, a large sale program would be a major drain on the available supply of funds and thus greatly worsen the liquidity problems of enterprises.

The government could recycle the funds received from sale back to the enterprises in three ways:

- the enterprise could be allowed to keep the funds received from the sale of its shares. For example, this is permitted by the Federal Law on Social Capital;
- the government could use the funds to repay debt owed by the government to the private sector; and
- the government could reinvest the funds back into the enterprises by loaning them money or buying additional equity shares. This is the concept behind the Development Funds that have been established in the Republics.

1. SALE OF NEW SHARES

Considering the first method, allowing the enterprise to keep the proceeds of sale would be effective in "recycling" the proceeds but would not result in privatization. To understand why, note that any corporation can sell new shares. This is a common way for a Western corporation to raise capital for modernization and growth. The proceeds of the sale of new shares is kept by the enterprise since this represents an addition to the equity capital of the enterprise.

Thus any Yugoslav enterprise could also sell new shares and keep the proceeds, but the status of the shares representing the old social capital is unchanged. Part of the capital of the company represented by the new shares would then have an owner. The social capital, however, would not have an owner.[25] Only if the proceeds of sale go to someone else, for example, the government or the Development Fund, can it be said that the social capital has an owner and has been privatized.

2. REPAYMENT OF GOVERNMENT DEBT

The second method of recycling is for the government to use the proceeds to retire debt owed to the private sector. This was the usual method of recycling sale proceeds in Western countries. In the past, the private sector loaned money to the government typically by purchasing government bonds. By buying back ("retiring") these bonds, the government returned the sale proceeds to private investors who can then invest the money in enterprises allowing them to modernize and expand.

The difficulty with this method of recycling is that Yugoslav governments typically do not have large debts owed to the private sector. Thus little of the proceeds of sale could be recycled in this way. The only significant Federal Government debt consists of Treasury bills issued to the National Bank of Yugoslavia in December 1990 to cover the foreign exchange losses of the banking system. This debt is estimated to be $10 billion (see Annex C).

In this regard, it is necessary to distinguish between government debt owed to foreign institutions and debt owed to Yugoslav citizens and institutions. The government's foreign debt ($15.8 billion, mid 1991 estimate) is larger than the domestic debt (though not large compared to some other Eastern European countries). The proceeds of sale of social capital to foreign buyers could be used to repay this foreign debt, but it is not practical to use the proceeds of sale to Yugoslav citizens to repay foreign debt. The proceeds of such a sale

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[25] Another possibility is if workers are allowed to buy shares at a discount as permitted by the Federal Law on Social Capital. In this case, the amount of old capital, ie, the social capital, is reduced. The reduction is equal to the discount given to the workers. Thus if workers buy a large amount of new shares at a discount, the social capital may be reduced to nothing. Another way of describing this process is that a worker buys a new share without a discount but is given a fraction of an old share for free. Thus the old shares are eventually given away to the workers as their discount for buying new shares.

would be in dinars, and thus the government would not obtain the necessary foreign currency to repay the foreign debt.

3. REINVESTMENT BY THE DEVELOPMENT FUNDS

The third method of recycling is for the government to reinvest the proceeds of sale back into the enterprises. This seems to be the concept behind the Development Funds established in each Republic. The Funds receive the proceeds of sale and then invest the money in other enterprises or even in the same enterprise that was just sold. In this way, it is believed that the Funds could encourage modernization and growth by providing badly needed capital to the enterprises. Such investment by the Funds can take two forms: (i) loans to the enterprises or (ii) the purchase of shares in the enterprises.

Though the Funds could be successful in recycling the proceeds of sale back to the enterprises, two facts should be kept in mind when evaluating this concept. First, most of the proceeds of sale would not be "new" capital. Instead it will be capital that would have been invested in the enterprises but instead was absorbed by the Funds through the sale of shares. The Funds will simply be putting back capital into the private sector that was taken from the private sector through the sale process.

Second, the Funds will either become the largest and most important financial institutions in Yugoslavia largely replacing the banks or become the major owners of Yugoslav enterprises. Because most of the available private capital will be absorbed by a large sale program, the Funds will become the primary source of capital for investment in enterprises. If the Funds loan the capital to the enterprises, they will largely replace the banks as a source of loans.

Alternatively, the Funds could buy shares in enterprises and thus provide them with equity capital. The Funds, however, would then become owners of enterprises. In this case, the Funds will have to be active owners, in other words, monitor the performance of the enterprises and intervene in their management if they are performing badly. If the Funds are a major shareholder and do not monitor the performance of the enterprises, there will be little incentive for the enterprises to improve operations and become more efficient. The Funds could become like giant holding companies owning shares in many companies.

As a result, an important issue is who owns and controls the Funds. If these Funds become just another bureau or agency of the Republic governments, these governments will be the major owners of enterprises and the dominant force in the economy. Socialism and government control of the economy will continue in Yugoslavia though in a different form.

One of the weaknesses of the Federal Law on Social Capital and the proposed Republic laws is that the concept of the Development Funds has not been adequately developed. These laws do not clearly explain what the role of the Funds will be in the economy and who will own and control them. One possibility is that the Funds themselves could be privatized by conversion into a private mutual fund or holding company. This could be done by giving shares in such a fund or holding company to all citizens.

If the end result is to be the conversion of the Development Funds into private mutual funds or holding companies, then why go through the long and expensive process of selling enterprises in the first place? Instead, the ownership of enterprises could simply be given to newly created mutual funds or holding companies. In turn, the ownership of these funds and companies could be given to all citizens of Yugoslavia. This option is discussed in more detail below in Section XI.

Thus in conclusion, there does not seem to be an adequate way to recycle the funds received from the sale of shares back to the private sector. Unless a method of recycling the funds is found, the sale process could drain the private sector of most of the available capital, reduce investment in modernization and growth, and increase the liquidity problems of enterprises.

H. SALE OF SHARES AS A SOURCE OF GOVERNMENT REVENUE

Another possible use of the proceeds from a sale of shares would be to supplement the revenues of the governments of Yugoslavia and reduce tax rates. The sale of shares could become a major source of new revenue for the government. Because of the current economic crisis in Yugoslavia, the Federal and Republic governments have seen a decline in their revenues from other sources.

On the one hand, this source of revenue could mean a reduction in taxes. As discussed above, reduced tax rates can be beneficial to the economy by reducing distortions and creating greater incentives for productivity. On the other hand, selling shares would reduce the capital available to enterprises for modernization and growth and increase the liquidity problems faced by enterprises. In effect, the increase in government revenue would be matched by a fall in investment. Such a decline in investment would only worsen the trend of the last decade or more of declining rates of growth.

It is unfortunate but true that additional government revenue if needed should come from an increase in taxes on incomes rather than through the sale of shares in enterprises. Taxes on incomes will primarily reduce consumption rather than reduc e the funds available for investment and growth.

One of the drawbacks of a program to sell shares in enterprises is that political pressure may be overwhelming to use the proceeds of sale to supplement government revenue. Once the proceeds are in the hands of the government, they may not be recycled back to the private sector in any of the ways discussed above. Though this would help to solve the short-run fiscal problems of the government, it is likely to reduce the long-run growth of the economy.

I. LAWS ON OWNERSHIP RESTRUCTURING

The Federal Government has passed a law on privatization, (the Law on Social Capital), which has been in effect in its current form since August 1990. Croatia and Serbia have also passed laws on ownership restructuring, and other Republics have laws in draft form. (A more detailed description of the Federal law is provided in Annex G, and the Republic laws in Annex H.)

Though there are some important differences between the various laws, the basic approach in each law is similar, and the proposed Republic laws have adopted many of the features of the earlier Federal law. In analyzing these laws, it is important to note that the Federal Government was constrained in it choices of privatization methods by the Constitution of 1974. The Constitution grants a whole spectrum of rights to self-managed firms, including the right to use social capital without any interference. The Federal Government did not feel that it had the authority to impose a change in ownership on such enterprises. Thus the Law creates incentives for an enterprise to change voluntarily its ownership structure rather than requiring that changes be made. This perhaps explains why the Federal Law and the subsequent Republic laws follow the general approach of "self privatization" or "spontaneous privatization."

Without discussing in detail the provisions of each law or the differences between them, a review of the basic approach is useful since these are the only actual examples of privatization laws in Yugoslavia. The general approach to privatization in the laws is as follows:

1 the basic method of privatization is through the sale of shares;

2 a number of important sectors of the economy are not to be privatized and are instead transferred to government ownership;

3 workers in an enterprise will receive a discount on the purchase of shares. These are generally referred to as "internal shares";

4 the proceeds of the sale of new shares representing new capital is to be kept by the enterprise while the sale of old shares representing the social capital is to go to the Development Fund;

5 the timing and method of privatization is determined by the enterprise with some control and supervision by the agency for restructuring in the Republic; and

6 any shares not sold by the enterprise are to be transferred to the Development Fund. The Development Fund is expected to sell these shares and has limited ability to control the enterprise in the meantime.[26]

Because of their basic reliance on the sale of shares as the method of privatization, these laws have the weaknesses described above in Section IX.

A common provision in these laws is that workers have a right to buy "internal" shares at a discount. The impact of this provision is uneven and likely to be considered unfair. The incentives created by the discount may be strong if the enterprise is profitable. In such enterprises, the workers would greatly benefit from the discount and would have a strong incentive to buy shares and speed up privatization. Workers in an unprofitable enterprise would not have this incentive and would not benefit from privatization. Workers and managers could end up owning a large proportion of the profitable enterprises while little progress is made in the privatization of the less profitable enterprises.

Since the enterprise keeps the proceeds of the sale of "internal" shares, some enterprises may receive substantial amounts of new capital while others receive little. There is little reason to believe that enterprises which will be able to raise substantial capital through the sale of internal shares have a greater need for this capital than other enterprises.

These laws also have a serious weakness relating to the fact that the enterprise is largely responsible for managing its own privatization which has been called "self privatization" or "spontaneous privatization." The natural incentive is for the managers and workers to carry out the privatization in the way most beneficial to themselves. They are likely to be quite imaginative and ingenious in finding ways to manipulate the process to their own advantage. In other Eastern European countries, the process of "spontaneous privatization" has been criticized because of these abuses. (For more discussion of this point see Annexes K, L, and M.)

The Republic restructuring agencies have certain rights to oversee and control the privatization carried out by the enterprises to stop these abuses. The agencies, however, may not have adequate staff with the proper skills to do this job effectively.

Another weakness with these laws is the possibility that workers will end up owning a large block of shares in an enterprise but not all of the shares. As discussed above, companies with a high proportion of employee ownership are rare in other countries. Thus the Development Fund may find it difficult to sell the balance of the shares to another investor, in particular, a foreign investor. Without the ability to control the company, a foreign investor will not wish to purchase the company or only purchase at a low price. Other weaknesses of a mixed enterprise combining private capital with social capital are discussed above.

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[26] The Federal Law does not have this provision and does not address the question of what will eventually happen to the shares of an enterprise representing the social capital which are not sold. The Federal Law leaves open the possibility that an enterprise may continue with a mix of private ownership and social ownership indefinitely.

X. SHARE GIVE-AWAY

The free distribution of socially-owned property to all citizens of the country is the third option to be considered. (Annex I discusses this option in more detail). At first glance, this may seem to be counter to normal standards of good business, good government, or common sense. Why should anything of value just be given away for free?[27] Naturally, if an asset had a clearly defined owner, that owner would object to giving away the asset to someone else without payment.

Social capital, however, has no individual owner and is owned by society in general. Consequently, if the social capital is given away free to all citizens, it is simply being given to those individuals who already owned it. The citizens of Yugoslavia are actually giving the social capital to themselves.

Another concern is that giving away the social capital may deprive either the government or the enterprises themselves of revenue. The government could use the sale proceeds to pay for badly needed government programs. The enterprise could use the proceeds to modernize and expand. However, as explained above, this money is not likely to be "new" money or a new source of funds for Yugoslavia as a whole. Selling enterprises to Yugoslav citizens in order to raise revenue for the government will absorb the savings of individuals and deprive enterprises of capital they need to modernize and expand. Alternatively, if the enterprises keep the proceeds of sale, privatization does not really take place since this would amount to a sale of new shares rather than existing shares. The shares representing the social capital have not been transferred to private ownership.

A. FREE DISTRIBUTION OF SHARES

Transfer of ownership rights to all citizens can be carried out in two ways: by direct distribution of shares to citizens or by the distribution of "vouchers". Direct distribution means than each individual would be given a bundle or "portfolio" of shares in various enterprises worth roughly $2,500 to $5,000. The shares in each portfolio would be different. It is not practical to give every individual, exactly the same portfolio. To make certain that the distribution is fair, however, the value of each individual's portfolio of free shares must be the same.

The only way that the value of each portfolio can be measured is to asses the underlying value of all the enterprises. This would be a lengthy and expensive task even in Western countries, but would be almost impossible under the current economic conditions in Yugoslavia. No matter how carefully the valuation is done, the subsequent performance of the company would deviate from the predicted thus making the value of one individual's portfolio greater than another.

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[27] It has sometimes been said that in Yugoslavia even the Federal and Republic governments should have to pay to take over ownership of socially-owned enterprises. This statement overlooks the question of who would receive the proceeds of a sale. Someone has to receive the money being paid? If the proceeds are to be kept by the government, it makes no sense to require the government to pay for the enterprise. The government would simply be paying itself. Sometimes it is argued that an enterprise should keep for itself the proceeds of a sale of its social capital. When examined more carefully, this is illogical. The new owners who have purchased the shares would get all of the money back that they have paid. They now own the enterprise and can do anything they wish with the assets of the enterprise including the proceeds of the sale. Much of this confusion stems from the fact that socially-owned enterprises have no current owners who in other countries would normally receive the proceeds of sale.

B. FREE DISTRIBUTION OF VOUCHERS

1. THE CONCEPT

The alternative is to give every citizen an equal right to buy shares. This right to buy is called a "voucher." The government would give such vouchers to all citizens. Vouchers would make up for the lack of financial assets that could be used by citizens in Yugoslavia to purchase shares.

Each individual could then bid to buy shares in particular enterprises using the vouchers as payment. Individuals could buy shares in one company or many companies depending on their own preference. The price of shares would be bid up or down depending on the demand of individuals for the shares of that enterprise. If the subsequent performance of an enterprise turned out to be worse than expected, shareholders could only blame themselves since they voluntarily purchased shares of that company. Vouchers would avoid the need for the government to undertake the difficult task of valuing each enterprise.

2. ADMINISTRATIVE PROBLEMS

Though a voucher system promises a quick privatization and is fair, there are a number of problems with this option. Some of these are administrative or practical in nature. No country has attempted to implement such a voucher system, including the auctions of shares that would be required, though Czechoslovakia is planning on a limited voucher system. Millions of Yugoslav citizens could be bidding to buy shares in thousands of enterprises. Considerable thought and planning would have to be given as to how this could be done in a practical way. (Annex I discusses possible types of auctions.)

The more serious problem is how can the citizens of Yugoslavia be expected to have the knowledge, experience, and information to make intelligent choices in bidding for shares. Because of the poor accounting systems in use in Yugoslavia, past financial statements would give little useful information about the future profitability of an enterprise. Moreover, most individuals have no experience in buying or estimating the value of shares even if substantial information was provided about each enterprise. The price of each share determined in an auction may bear little relationship to the future profitability of a company. In practice, a voucher scheme may be little different from a lottery where shares would be given at random to individuals.

3. IMPACT ON CORPORATE GOVERNANCE

The most serious objection to the voucher scheme is that it would do little to improve corporate governance since the result is likely to be widespread ownership of each company by many individuals. Individuals would lack the expertise to monitor performance and would have little incentive to spend much time and effort on monitoring because of the small amount of shares owned in any one company.

Eventually as individuals sell their shares, share ownership would become more concentrated and thus corporate governance would improve. Wealthy individuals, other enterprises, and financial institutions would own larger blocks of shares and play a larger role in the management of the enterprise. How long this process of ownership concentration would take is difficult to determine.

C. FISCAL AND MACROECONOMIC IMPACTS

Another disadvantage of a voucher system is that it could cause an increase in consumption resulting in either inflation or a reduction in investment and the rate of growth. A free distribution of shares would make individuals feel wealthier causing them to spend more on consumption. Even if they did not actually attempt to sell the shares to pay for additional consumption, they would have greater wealth and thus have less need to save for the future.

Such an increase in consumption and reduction in saving could cause inflation as everyone attempted to buy more. Alternatively, it could mean that less funds would be available to enterprises for modernization and expansion and a reduced rate of economic growth in Yugoslavia.

In conclusion, a share give-away using vouchers is appealing because it could be done quickly and would be considered fair. Unfortunately, it would also be difficult to implement and do little to achieve the most important objective, namely, to improve corporate governance.

XI. TRANSFER TO INSTITUTIONAL OWNERS

The fourth group of options involves transferring ownership of enterprises to institutions such as banks, mutual funds, pension funds, and holding companies. In some cases, these institutional owners do not now exist in Yugoslavia and would have to be created. The shares of enterprises would be given to these institutions without payment. Thus this transfer could be considered as another share give-away option. In turn, ownership of these institutions would be given away to all citizens. The end result would be that citizens would own the institutions which in turn would own the enterprises.

A. THE GENERAL CONCEPT

These options involving institutional owners would follow the pattern of ownership found in Western countries. As discussed above, Germany and Japan have a long tradition of banks owning shares in enterprises. In the United States, bank ownership is prohibited, but instead pension funds and mutual funds own a large proportion of shares of enterprises.

Another term for these institutional owners is "financial intermediary." As the term "intermediary" implies, these institutions would stand between Yugoslav citizens and the enterprises and act as the agents for the citizens by monitoring and overseeing the management of the enterprises. The enterprises would pay dividends to the intermediaries which in turn would pay these revenues to Yugoslav citizens or reinvest the funds in other enterprises. Later, additional savings of individuals could be channeled through these intermediaries for investment in the enterprises. In this way, the intermediaries may provide new capital to enterprises using additional funds received from citizens.

Two of these types of institutional owners already exist in Yugoslavia -- pension funds and banks. By transferring ownership of enterprises to pension funds, the funds would then have a new source of revenue to pay pensions. Similarly, banks would have additional assets that would help to restore their financial health.

Though the general concept is the same, the details will vary depending on which type of institution is used. The strengths and weaknesses of using specific types of institutions is discussed in more detail in the later Section XIII which presents a recommended option for Yugoslavia.

B. FISCAL AND MACROECONOMIC IMPACTS

Using the social capital to rehabilitate the banks or to "capitalize" pension funds have important fiscal and macroeconomic advantages compared to the other options. The key advantage is that the government would be reducing its future expenditures and thus reducing the need to levy taxes. In effect, the government is using the social capital to reduce its liabilities.

The government has an obligation to rehabilitate the banks because the government guarantees bank deposits. If social capital is not given to banks to increase their assets, the government will have to provide the funds thus leading to an increase in taxes. Similarly, the government has an obligation to provide pensions. If the social capital can be used to capitalize private pension funds, the need for the government to tax enterprises to pay for pensions will be reduced.

C. CORPORATE GOVERNANCE

Transferring ownership to banks, mutual funds, or pension funds would be following the example of Western countries where these financial intermediaries play an important if not dominant role in corporate governance. In that sense, this option should not be considered new or experimental but instead follows a well established model. These financial intermediaries, however, either do not exist in Yugoslavia or exist in a form that is not suitable for this new role of owning enterprises. Considerable analysis and planning would have to be undertaken to develop a practical proposal to create these institutions.

One issue is whether just a few or many financial intermediaries should be created. On the one hand, there may not be enough people with the managerial, financial, and accounting skills to staff more than a few such institutions. On the other hand, transferring all the social capital to just a few institutions would give them considerable economic power. There is the risk that they might become large bureaucracies facing little competition or pressure to perform well. They might collude amongst themselves to limit competition and keep prices and profits high. They could also become a vehicle for continued government control and management of the economy.

Another issue is whether all the shares in an enterprise should be given to one institution or equal amounts to all. Giving ownership to just one institution would give that institution considerable power to control the activities of the enterprise and thus ensure that it is well managed and profitable. The risk, however, is that if the institution is not doing a good job of supervising the activities of the enterprise, there are no other owners who could step in and exercise some control over the enterprise.

Whatever initial type of ownership structure is created, it should be allowed to evolve and change over time and should not be thought of as being final and permanent. For example, it is likely that an institutional owner may wish to sell some of its shares in an enterprise or buy shares in another enterprise. This should not be discouraged.

As another example, a foreign company may wish to buy a particular enterprise because the foreign company has a plan for improving the profitability of that enterprise. An institutional owner should recognize that it can receive a higher value for its shares by selling them to the foreign buyer. There will be a natural tendency for the ownership of an enterprise to be transferred to those individuals, enterprises, funds, or other institutions who can best manage the enterprise and have the best plan for improving its operations.

Thus the option of transferring ownership of enterprises to institutions also includes the sale option. Selling enterprises to foreign or Yugoslav investors would still occur if such investors show an interest in purchasing Yugoslav enterprises. The institutional owners would have a natural tendency to sell their shares in an enterprise if the buyer was willing to offer an attractive price. The proceeds of sale would automatically be recycled since the institutions would reinvest the proceeds of sale by either making loans to enterprises or by buying shares in other enterprises. This type of sale avoids the recycling problem identified above when the sale is carried out by a Development Fund, the government, or the enterprise itself.

In a similar way, the institutional owners will have an incentive to carry out the restructuring of particular enterprises or even of entire industries if that will improve efficiency and profitability. If an enterprise would be more efficient if broken up into smaller enterprises, the institutional owners would insist that this break-up be carried out. If too many small enterprises exist, the institutional owners would have an incentive to negotiate with other owners to merge or combine enterprises.

A great deal of responsibility would rest with these institutions to ensure that enterprises are efficient and profitable. At least initially, the institutions may not have the staff with the skills, training, and experience to carry out the complex tasks required of an owner of enterprises. It must be observed that almost no one else in Yugoslavia has these skills either, but the new institutional owners are likely to have the incentives to develop these skills. Initially, they could hire foreign consulting firms to assist and train their own staff.

Competition between institutional owners for members would also create an incentive for them to do the best job possible of overseeing and monitoring the operations of enterprises. Members should be free to transfer their accounts from one institution to another.

In conclusion, transferring ownership to institutional owners has many advantages. It could be done quickly. By transferring ownership of the these new institutions to all citizens, the resulting distribution of the social capital would be considered fair. Though ownership of enterprises by such institutions is common in Western countries, new institutions would have to be created in Yugoslavia. Considerable thought would have to be given as to exactly what type of institutions to create and how they would be structured.

XII. OWNERSHIP RESTRUCTURING IN EASTERN EUROPEAN COUNTRIES

The other countries of Eastern Europe are also attempting to restructure their socialist economies along the lines of Western capitalist countries. Though Yugoslavia had more of a market oriented economy than other Eastern European countries, some of these countries have made greater progress in the area of ownership restructuring. Yugoslavia may be able to learn and benefit from this experience.

Though the ownership restructuring programs in other Eastern European countries may be more advanced than in Yugoslavia, they are still in the preliminary stages. In some cases, the overall programs are just now being defined and in no cases have the programs been in effect for more than a year or so. It is hard to draw firm conclusions from this experience. The following analyzes the programs in three countries -- Hungary, Czechoslovakia, and Poland. These were chosen because their programs are more developed and there is some limited experience with their operation.

An important question is which of the four options discussed above are being adopted by these three countries. The answer seems to be that all three propose to rely heavily on the sale option but are also considering or experimenting with the other options. In particular, Czechoslovakia is planning on giving some shares away using vouchers while Poland is planning on giving at least some shares to newly created institutional owners.

A. HUNGARY

More than in most other Eastern European countries, Hungary has emphasized the sale option (see Annex K for a more complete description). This seems to be due to the fact that Hungary has the largest outstanding foreign debt relative to the size of its economy of any Eastern European country. The intention seems to be to use the proceeds of sale to repay this debt. The total amount of the debt is roughly $22 billion.

Hungary seems to be following the example of privatization in Western countries. The State Property Agency (SPA) will sell each enterprise either through selling shares on the stock market to many investors (called a stock market "flotation") or through auctions and bidding by just a few individual investors. Western investment banking and accounting firms will be hired to organize and manage each sale. The SPA will be responsible for the sale of some 2,200 larger enterprises with a book value of about $26 billion.

The program in Hungary raises all of the issues concerning the sale option discussed above. If a rapid sale of enterprises is attempted, will Hungary receive the fair market value? If not, will the citizens of Hungary view this as being unfair or inequitable? If the sale takes a long time, how will the enterprises be managed in the meantime to stop managers and workers from taking the assets for themselves. If the goal is to repay foreign debt, is it possible to attract foreign investors? How will the sale proceeds be recycled to the private sector so that enterprises are not deprived of the capital they need to modernize and grow?

Unfortunately, the Hungarian experience to date provides few answers to these questions. The SPA was formed in March 1990, and its first program to sell some 20 enterprises was only begun in September 1990. The SPA predicts that it will sell about 1,250 enterprises (57 percent of the 2,200 total) by 1996 or about 200 per year. This is a very ambitious goal that would greatly exceed the number of enterprises sold by any Western country over a comparable time period. The biggest constraint is that the SPA only has a staff of 120.

Hungary has had the most success with privatizations initiated by the enterprises themselves. Prior to the creation of the SPA, 150 enterprises were "spontaneously privatized" including the well known purchase of the Hungarian light bulb manufacturer, Tungstam, by the US firm, General Electric. A criticism of such privatizations is that managers were selling enterprises without competitive bidding for low prices. The SPA now regulates the process in an attempt to stop these abuses but hopes that such privatizations will still continue at a rapid rate.

Hungary had a system of worker self-management similar to Yugoslavia. The ownership of enterprises has been transferred to the SPA as the first step in privatization. It is unclear whether the SPA is taking an active role as the new owner and is trying to improve the governance of these enterprises pending sale. If sale is likely to be delayed, the role of SPA as the owner becomes even more important.

The success of the Hungarian program largely depends on whether foreign investors will purchase the enterprises offered for sale and thus bring in the necessary foreign exchange to allow Hungary to retire its foreign debt. Sale to Hungarian citizens would not raise the foreign exchange necessary to repay foreign debt. Hungary has put in place the most favorable investment laws in Eastern Europe to attract foreign investors including a tax reduction of 60 percent in certain cases. As a result over half of all foreign investment in Eastern Europe has been made in Hungary. In spite of this, the total of foreign investment to date is only about $1 billion. This is just a small fraction of the amount required to buy the enterprises offered for sale or to retire the foreign debt.

B. CZECHOSLOVAKIA

Though there is little experience with the Hungarian program, there is even less experience with the Czechoslovakian program. The basic program for restructuring the ownership of large enterprises was set forth in legislatiòn in February of this year and implementation has only begun.[28] Details of the program are unclear and may change (see Annex L).

The emphasis of the Czechoslovakian program as in Hungary is on the sale of enterprises, but Czechoslovakia is considering other approaches as well. A large proportion of the equity in many enterprises may be given away to all adult citizens using a voucher system. The details of the voucher system are still being developed. The current thinking is that citizens would have to pay a nominal sum to buy the vouchers. This is to discourage those with little interest in the program and to encourage holders to take an interest in the management and performance of the enterprises. The vouchers could then be used to bid for shares in auctions to be held next year.

There is also some discussion of using vouchers in combination with mutual funds. Individual citizens would transfer their vouchers to mutual funds who would in turn use the vouchers to buy shares in enterprises.

Another interesting feature of the Czechoslovakian program is that ownership of enterprises is to be transferred to "Property Funds." This is referred to as "horizontal privatization." The Property Funds would

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[28] The Czechoslovak program for the sale of small enterprises is much more advanced than the program for large enterprises. Czechoslovakia expects to sell up to 200,000 small enterprises such as retail outlets, hotels, restaurants, etc by the end of 1992.

be the temporary owners of the enterprises, be responsible for restructuring or liquidation if necessary, monitor and oversee the performance of the enterprises until they are sold, and sell the enterprises. The Funds would be under the direction of a board of directors elected for a five year term. The directors must not be government officials.

These Funds are similar to the Development Funds created in Yugoslavia. One important difference, however, is that the Property Funds have a clear objective to assure that the enterprises are well managed until they can be sold. In other words, these Funds will have to establish a system of corporate governance and be active owners. In contrast, the Development Funds in Yugoslavia are proposed to be passive owners having little control over the enterprises that they own.

The Property Funds have considerable discretion as to their role and objectives. Like the Development Funds, they may reinvest the proceeds of sale back into the enterprises, for example, to restructure them so that will be more attractive to buyers. It is not clear how Czechoslovakia plans to deal with the recycling problem discussed above. If the Funds in Czechoslovakia reinvest the proceeds of sale back into enterprises, the Funds will continue to own enterprises and thus not advance the goal of privatization.

Though Czechoslovakia also wishes to attract foreign investment, it has not been even as successful as Hungary. On reason is that the laws on foreign investment and taxes do not appear to be as favorable as in Hungary.

C. POLAND

Though Poland also plans on selling many enterprises, Poland announced in June of this year a "mass privatization program" or MPP. The plan is to transfer 60 percent of the shares in 400 large enterprises to newly created funds called National Wealth Management Funds (see Annex M). The ownership of these funds would in turn be given without charge to all citizens. The actual method of transferring ownership of the funds to citizens would be to give each citizen a voucher called a "Participation Certificate." Citizens could then trade their Certificates for shares in the Wealth Management Funds of their choice. Thus this approach can be thought of as a combination of the option of giving shares away using vouchers and the option of creating institutional owners.

In addition to shares given to the Funds, ten percent would be given free to employees. The balance of the shares (30 percent) would be retained by the government (see Table 1).

One third of the shares in each enterprise would be given to a "lead" Fund that would take primary responsibility for monitoring the performance of that enterprise. The other shares would be dispersed among all of the Funds.

It is expected that the Funds would hire international banks and investment management firms to help with the management of the Funds. The Funds would be organized as joint stock companies with a Supervisory Board (board of directors) elected by the shareholders. It is expected that members of the Board would be experienced businessmen both from Poland and foreign countries. The Funds seem to have wide discretion in exercising their control over the enterprises in which they own shares. For example the Funds can sell new shares, borrow to raise capital, and sell

Table 1 Distribution of shares in the Polish Mass Privatization Program

OWNER	%
Lead Fund	33
Other Funds	27
Employees	10
State	30
Total	100

Source: Ministry of Ownership Changes (1991) their shares in enterprises to other investors. In this regard, the Funds would be more like holding companies than mutual funds.

It is not entirely clear why the Polish government wishes to retain a partial ownership of these enterprises (30 percent) or what the government intends to do eventually with these shares. It is mentioned that these shares might be turned over to the social insurance or pension system while others have speculated that the government may wish the Funds to manage these shares on behalf of the government.

The 400 enterprises included in the Mass Privatization Program only account for about 25 percent of all enterprises (measured by sales). The question is how does Poland plan to privatize the balance of the approximately 9,000 state-owned enterprises. It appears that Poland intends to follow a conventional case-by-case sale approach. Poland's goal is to privatize a majority of its state-owned enterprises over the next five years, but Poland plans to sell only 40 to 60 enterprises to domestic and foreign investors by the end of the year. Thus to achieve the goal of selling such a large number of enterprises, the pace of the sale program will have to be increased dramatically. Again such a sale program raises all of the questions discussed above in the case of Hungary.

XIII. THE RECOMMENDED OPTION

A. PRIVATIZATION ACHIEVEMENTS TO DATE

Prior to analyzing the need for changes or new approaches, it is useful to discuss privatization trends prevailing in the country based on existing laws. Privatization of socially-owned enterprises started in Yugoslavia in 1990 after the enactment of the Federal Law on Social Capital. It is interesting to note, however, that the Federal Government has never prepared a document spelling out its privatization intentions and objectives, the strategy for achieving those goals, methods and techniques of privatization, etc. Similarly the Republics have not published detailed privatization programs. One explanation is that, given the unstable political situation, they hesitate to initiate clearly defined programs for privatizing socially-owned enterprises. As a result, privatization policies and programs are unclear, subject to many interpretations, and taking place as a decentralized process.

Privatization of housing actually began prior to the Federal Law on Social Capital with an attempt to sell socially-owned flats to their tenants in 1989. The total number of social flats or dwelling units is about 1.5 million. According to available information, the tenants have shown interest in buying the flats, but up to now only a small number of sales have been made (less than 100,000). This seems to be due to three problems. First, the prices of social flats are set too high. Second, the rents on social flats are relatively low. Third, there are certain legal obstacles in establishing full ownership rights by the new owners. As a result, the tenants can afford to buy only those flats which are small and low priced. The Republics are now forced to amend the laws which allow for the privatization of socially-owned flats and make the purchase of flats more attractive to tenants.

Laws enacted since 1988 at the Federal and Republican levels permit another form of privatization, namely, social enterprises can enter into a variety of contracting-out and leasing arrangements with private investors. An example is the privatization law in Serbia which makes explicit provision for contracting-out and leasing part or the entire social enterprise. In practice, these arrangements often include a clause allowing the private investors to buy socially-owned property over a certain period of time and pay for it in installments. These arrangements are in fact privatization schemes, since they allow that social property which is contracted-out or leased to be sold to the private investor at some future date.

There is no official data on the number of contracting-out, leasing, or similar arrangements in Yugoslavia, since they are made independently by each social enterprise. The Government of Serbia has the right to supervise and approve such arrangements only if and when they include the sale of social property.

Unofficial and not very reliable data indicate that at least a few thousands shops or parts of enterprises have been privatized in this way.[29] This has mostly occurred in retail trade, service activities, restaurants, etc.

Considering so called "large scale" privatization experience in the two Republics which have enacted privatization laws (Serbia and Croatia), two interesting conclusions result. The first conclusion is that both Republican laws show the intention of these governments to nationalize a large part of social capital (25 percent in Serbia and 40 percent in Croatia). Both Republics are nationalizing only very profitable enterprises (oil, gas, electricity) and those that form the backbone of the republican economies (the enterprises of special social interest, as they are called).

This seems to indicate that one of the main objectives of nationalization might be a desire to appropriate profits of state-owned enterprises and substitute this source of revenue for tax revenues. If this is the case, it could be beneficial to the economy in the short run, since a lower tax level will tend to stimulate savings, new investments, and economic growth. Some nationalizations in the two Republics (roads and water management, air transport, postal system, telephone, and public utilities) also indicate that the intention of the governments might be to assure low prices for these services since natural monopolies are likely to exist in these sectors.

The ultimate intentions of the Governments of the two Republics in respect to nationalization are not known. Both Governments in the not so distant future may sell partially or completely some of the enterprises they have nationalized.

The second conclusion is that both Republican laws strongly favor the option of selling socially-owned enterprises to the workers and managers ("internal owners"). This privatization strategy has not proven to be very successful, so that both Republics are likely to amend their privatization laws.

At least three problems have occurred in attempting to sell enterprises to workers and managers. First, the workers and managers have shown a strong interest only in buying internal shares of profitable enterprises. Up to now there has not been a single case where the workers and managers have tried to purchase (by the issue of internal shares) an unprofitable enterprise. This experience is in contrast to that in Western economies where employee buy-outs of troubled companies rather than profitable companies are more common.

Second, the managing bodies of the enterprises (workers councils) have understandably been inclined to underestimate the value of the social capital in their firms as a basis for setting the price of internal shares. The workers and managers have shown little interest in buying internal shares if the valuation of social capital is done under the control of the restructuring agency or some other governmental agency..

Third, the workers and managers have not shown an intention to supply enterprises with additional capital. In fact, they are willing to become owners of their enterprises and buy internal shares only if they can purchase the shares in installments and pay for them out of their future income from dividends. In other words, the workers and managers are not inclined to play the role of owners if it means that they have to supply their enterprises with badly needed new capital, i.e. if they have to increase their savings and reduce consumption.

As a result, the enterprises privatized by internal share issue face exactly the same problems they used to face before their privatization -- lack of working capital and severe liquidity constraints. Most probably this is the main reason why the Governments of the two Republics are reexamining their privatization strategies and may amend existing privatization laws.

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[29] *Politika*, October 26, 1991.

B. ANALYSIS OF OPTIONS

Of the four options discussed above, transferring ownership to institutions seems to be the best when measured against the three criteria set forth initially -- improving corporate governance, fairness, and speed. In addition, this option has desirable fiscal and macroeconomic impacts that should be taken into account.

In comparison, the first option (transferring ownership to the government, i.e. nationalization) would do little to improve corporate governance. However, it could be done quickly and would be fair since all citizens would benefit from the future profits of the enterprises. Enterprises owned by the government in other countries have proven to be inefficient and often lose money. For Yugoslavia to adopt this option would be counter to the trend in most Western countries and in Eastern Europe. It can only be hoped that the current policies in many of the Republics to take over ownership of enterprises is a temporary solution and that the Republics plan to transfer ownership soon to private individuals and institutions.

The second option (selling enterprises) poses a difficult dilemma. If sale is spread out over decades, it may be possible to sell enterprises for a fair price to new owners (both foreign and domestic) who would have the ability to make certain that the enterprises are well managed and efficient. In other words, if the objective of a rapid restructuring of ownership is sacrificed, the other two objectives (improvement in corporate governance and fairness) might be achieved.

A rapid sale, however, would result in low prices for socially-owned capital thus benefiting that minority of citizens who have some financial assets now. A rapid sale would only be possible if many citizens bought shares, but such a dispersed ownership would do little to improve the management and efficiency of enterprises. If the ownership restructuring does not occur quickly, there is the substantial risk that the operation of enterprises and thus the economy as a whole will continue to deteriorate and that managers and workers may find ways to take the assets of the enterprises for themselves.

A common argument for selling enterprises is that this would raise money either for the government or the enterprises themselves for modernization and growth. It must be remembered, however, that the proceeds of sale to Yugoslav citizens does not represent new capital or a new source of money for the economy as a whole. Instead, it is merely a reshuffling of existing capital. If the proceeds of sale are kept by the government, sale would absorb funds that would otherwise have been used by enterprises to modernize and expand and would worsen the liquidity problem now faced by enterprises. There does not seem to be a satisfactory way of "recycling" these funds back to the enterprises.

Only if the enterprise is sold to a foreign investor is it likely that new capital will be injected into the Yugoslav economy. For this reason, our recommended option discussed below leaves open the possibility of selling enterprises in the future to foreign investors if and when such investors are willing to invest in Yugoslavia.

The third option (giving away shares to all citizens) could be carried out quickly and would probably be considered fair. This option, however, would do little to improve corporate governance. Ownership of each enterprise would be dispersed among thousands of individuals who would have little incentive and ability to monitor and control these enterprises.

A further problem with giving away shares is that such a sudden increase in wealth in the hands of individuals could increase consumption and reduce savings. This in turn could either cause inflation or reduce the level of funds available for investment by enterprises in modernization and growth.

The fourth option (transfer of ownership to institutions such as pension funds, mutual funds, holding companies, and banks) offers the one hope of achieving all three objectives. The transfer could be done quickly and would probably be considered fair. The improvement in corporate governance would depend on how fast these institutions develop the skills and knowledge to oversee and supervise the operations of enterprises, in other words, become good owners of enterprises. Yugoslav banks have considerable experience in this area. Other possible institutional owners, however, either do not now exist (mutual funds and holding companies) or do not have the skills to monitor the performance of enterprises (pension funds). These institutions could develop the skills required because they would have a strong incentive to do so.

The option may also have desirable fiscal and macroeconomic impacts. Transfer of ownership to banks or pension funds would relieve the government of its obligations to rehabilitate the banks and pay pensions to the workers. Thus future tax levels could be reduced which promotes an efficient and productive economy. Moreover, the privatization of the pension funds would give workers a strong incentive to save more of their income for retirement. This would increase the funds available to enterprises for modernization and growth and help to solve their current liquidity problems.

Though transfer of ownership to institutions appears to be the best option, there are many issues and questions about how to implement this option that need to be analyzed. One important issue is who will own or control the institutions.

C. CHOICE OF INSTITUTIONAL OWNERS

Four types of institutional owners will be considered: banks, mutual funds, pension funds, and holding companies.

1. BANKS

As in Germany and Japan, banks in Yugoslavia could own shares of enterprises. Normally in Western countries, banks would buy shares in enterprises using funds deposited with the bank by its customers, for example, in savings accounts. The dividends paid by the enterprises to the bank would in turn be used to pay interest on the saving accounts.

In Yugoslavia, the situation is somewhat different for two reasons:

- currently banks are owned by the "founding" enterprises. Thus in contrast to other countries, enterprises in Yugoslavia own the banks rather than the banks own the enterprises;

- as a result of bad loans to enterprises, most banks are insolvent. The value of their assets (primarily loans to enterprises) is less than their liabilities (primarily deposits made by the bank's customers). The most recent estimate is that the liabilities exceed assets (i.e. negative net capital) by about $8 billion (see Annex J).

Ownership by the founding enterprises is the formal or legal position of Yugoslav banks. In reality, the enterprises have never played the role of real owners of the banks since the enterprises have been heavily dependent on bank loans. As a result, the banks largely controlled the enterprises through their control of new funds.

In turn, the government and the Communist Party have largely controlled the banks. Republican and local governments had effective control over banks because they had the power to supply the banks with new capital. Under pressure from enterprises, banks, and regional governments, the National Bank of Yugoslavia and the Federal government had to print new money almost continuously to meet the need for credit by enterprises. As a result, hyper-inflation was created at the end of 1989. A more restrictive monetary policy followed resulting in the worsening of the economic crisis.

In conclusion, the accumulation of bad loans is not a result of the fact that enterprises legally owned commercial banks or that the banks were lacking experience and knowledge. It is the result of the goal of governments and the Communist Party to protect the existing economic system of the country by requiring banks to subsidize insolvent enterprises.

Consequently, the government has a program of bank rehabilitation to restore the banks to financial health and to assure that depositors can obtain their money (this rehabilitation plan is described in Annex J). In simple terms, this rehabilitation plan involves the government replacing the bad loans to enterprises with government bonds.[30] Thus the value of a bank's assets will be increased to match its liabilities. Interest payments on the government bonds and the repayment of those bonds will give the banks the money they need to pay their depositors. Note, however, that this represents a major increase in government expenditures. The government will have to increase tax revenues to pay the interest and principal on these bonds.

Ownership restructuring of enterprises could also be used as a mechanism for bank rehabilitation. Shares of enterprises could be transferred to insolvent banks to increase their assets. Using the above estimate, $8 billion worth of social capital would have to be transferred to the banks to eliminate their net negative capital. Dividends received on those shares and the sale of the shares themselves would be used by the banks to pay their depositors.

Banks as the new owners of enterprises would have to develop further their ability to monitor the performance of the enterprises, appoint members of the board of directors of these enterprises, and if necessary change the management. A bank would have a strong incentive to assure that these enterprises were efficient and profitable since the shares in these enterprises are a large part of the bank's assets.

As a result of long experience in commercial banking, Yugoslav banks should be capable of performing this task. They have already developed skills in monitoring enterprises and have the necessary experienced personnel. In comparison to other Eastern European countries, the banking system in Yugoslavia seems well prepared to play its role as a modern financial intermediary in a market economy. This is a major advantage of the country in developing and implementing a privatization program.

If this general approach were to be followed, there are some issues that need further analysis:

- would a bank be given shares in just a few enterprises or would it be given a diversified portfolio of shares in many enterprises. If an enterprise is owned by many banks, the banks may have less control over it. A bank, however, may prefer to own shares in many companies because there is less risk to the bank if one enterprise loses money. Also if only shares in one or two enterprises were given to a bank, then it becomes much more important that those shares be accurately valued.

- banks in Yugoslavia compared to banks in other countries would be large owners of enterprises and shares in enterprises would amount to a large proportion of the assets of banks (roughly 40 percent on average). Because ownership of shares is a more risky investment than loans, most countries have limits on the amount of equity that banks may own. Thus the banking system in Yugoslavia may be out of step with standards in other countries.

- who would own the banks? Even after rehabilitation, shares of banks would be worth little, but still someone must own the banks.

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[30] Technically, these may be bonds issued by the National Bank of Yugoslavia, but they still represent a liability of the Federal Government. An alternative is for the Republics to take responsibility for bank rehabilitation. In this case, the Republic governments would have to provide the necessary Republic bonds to supplement the assets of the banks.

2. MUTUAL FUNDS

Mutual funds (also called unit or investment trusts in some countries) are a way for individuals to pool their funds and buy shares of many enterprises. Individuals buy shares in the mutual fund which then uses the money to buy shares in enterprises. Mutual funds contribute to economic growth by collecting the dispersed savings of many individuals and use them to provide long-term equity capital to enterprises. The enterprises pay dividends to the mutual fund which in turn pays dividends to the members of the fund. The value of the mutual fund shares held by its members goes up and down in step with the value of the enterprise shares owned by the fund.

In Western countries, mutual funds have various philosophies for investing the money of their members. Some mutual funds only buy shares in certain industries. Some buy shares only in companies that are expected to grow rapidly while others buy shares in companies that pay high dividends. Some managers of mutual funds closely examine each enterprise and attempt to choose which enterprises are likely to be the most profitable. In other cases, managers buy a proportional amount of shares in all companies (so called "indexed" funds).

Mutual funds can influence the management of enterprises in two ways. First, they can attend the annual meeting of the company and elect members of the board. If a fund owns a large enough block of shares in a particular company, it could insist on having its own representative on the board of directors to monitor the performance of the enterprise. In the past, however, mutual funds usually did not exercise this right to elect their own members of the board. This has changed somewhat in recent years as mutual funds have taken a more active role as owner. Second, mutual funds can sell their shares in the enterprise if they are dissatisfied with its performance.

Just as mutual funds should monitor and oversee the performance of enterprises, the members of the mutual funds should monitor and control the funds. Again this could be done in two ways. First the fund could be established in such a way that the members elect a board of directors who manage the fund. Second, the members can transfer their investment from one fund to another. A mutual fund that does not seem to be doing a good job would find that its members are transferring to other mutual funds, and thus there would be competition between mutual funds to attract members.

In Yugoslavia, mutual funds could be a vehicle for giving away shares of enterprises to all citizens. Since mutual funds do not exist in Yugoslavia, they would have to be created. Such funds should be entirely private and under the control of their members. Government control over the funds should be avoided since the funds could become an agent of the government to control enterprises.

Shares in enterprises would have to be transferred to the mutual funds, and Yugoslav citizens would have to choose which mutual fund they wish to participate in. Because only a limited number of mutual funds would be involved, the distribution of enterprise shares to the funds is much simpler than in the case of giving away enterprise shares directly to citizens as discussed above.

The following are two examples of how the distribution might be done:

- <u>direct distribution</u> Each mutual fund would be given a portfolio of shares with the same total value. The simplest way of doing this would be to give each fund the same number of shares in each enterprise, and thus all funds would have exactly the same portfolio of shares. Each citizen would then be given a membership in one of the funds.

- <u>vouchers.</u> Instead of the government determining the distribution of shares and choice of mutual fund, citizens and the funds could have a greater choice using vouchers. Each citizen would be given one voucher. Individuals would then chose which mutual fund they wish to participate in and turn over their vouchers to the funds. The funds would then bid for shares of enterprises in auctions using these vouchers. The end result is that the mutual funds might be quite different in size depending on how many individuals chose to participate in each fund, and the portfolio of shares owned by funds could be very different depending on which shares each fund chose to purchase.

3. PENSION FUNDS

The third type of institutional owner is pension funds.[31] Pension funds are similar to mutual funds. The primary difference is that the capital accumulated by individuals in the fund is intended to be used to pay a pension to the individuals after retirement. In contrast, individual members in a mutual fund can take out the capital accumulated in the fund at any time and use the money for any purpose. Based upon the capital accumulated in the pension fund by individuals at the time of retirement, the fund agrees to pay a pension to the individuals over their remaining lives.[32]

In a private pension fund, each member can choose how much he or she wishes to contribute to the fund and thus how large a pension they will receive upon retirement. The pension fund uses this money to buy shares in enterprises or loans money to enterprises (for example, by buying enterprise bonds). Since providing for retirement is a primary reason why individuals save, pension funds have become a major source of new capital for enterprises in many countries.

Like mutual funds, the pension funds would have to monitor and oversee the management of enterprises in which it has purchased shares. Only in this way can the fund be assured that the value of its investment in the enterprises will grow and that the enterprises will pay dividends. Without these dividends, the fund would be unable to meet its obligations to pay pensions.

Because pension funds have an obligation to provide pensions to their members, such funds tend to be conservative in their investments and to avoid risk. For example, they would most likely prefer to own shares in many enterprises (a "diversified portfolio") and not be excessively reliant on the success or failure of just a few enterprises.

Pension funds do exist now in Yugoslavia but are quite different from those described previously. These are government controlled and do not accumulate capital or invest that capital in enterprises. Instead, the money received from taxes on enterprises is used to pay the pensions of those now retired.[33] This type of pension fund is referred to as a "pay as you go" fund.

These existing government pension funds could both be "privatized" and "capitalized". The government would "privatize" these funds by converting them into private funds following the principles set forth above. They would be managed and controlled by the members who chose to participate in each fund. The members would have to contribute the necessary capital while they were working so that the fund could pay them their pensions when they retire. The government would no longer agree to pay pensions to workers, and the pension funds could not tax enterprises to obtain the necessary funds. The members could switch from one fund to another by transferring their capital account and thus create an incentive for good management of the funds.

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[31] Professor Steve Hanke of the Johns Hopkins University has developed this option for Yugoslavia. See Hanke (1990) and Hanke (1991).

[32] The pension fund must estimate how long on average its members will live. The capital accumulated by individuals who die sooner than expected is used to pay the pensions of those who live longer than expected.

[33] Though these taxes are sometimes called contributions, they are usually not voluntary.

Though this privatization of pension funds is reasonable for young workers just beginning their working career, what would happen to older workers who only have a few years until retirement? These workers have been relying on the current pension system to provide them with a pension and do not have time to contribute the necessary capital into the funds before they retire.

To solve this inequity, the government would agree to provide the necessary capital for current workers. In other words, the pension funds would be "capitalized" by the government using shares in socially-owned enterprises. The capital necessary to pay a particular worker's pension would be a combination of the capital provided by the government when the pension fund was established and the subsequent contributions of the worker during the rest of his or her working career.

The conversion of government pension funds into private pension funds would have a desirable macroeconomic impact. When younger workers realize that the government will no longer provide them with the pension they desire for retirement, they will then have an incentive to increase their savings and to contribute to the private pension funds. When this conversion of government pension funds into private pension funds occurred in Chile, the level of savings increased substantially contributing to economic growth in that country.[34]

No one has estimated how much social capital would be required to "capitalize" private pension funds for all individuals. This would depend primarily on the level of pension that the government would agree to capitalize. Individuals could then choose which pension funds they wish to become members in. The government could then calculate how much capital would have to be distributed to each fund to capitalize the pensions for the individuals choosing that fund. As with the mutual fund proposal, there are a number of practical ways that the shares in enterprises could be distributed to each pension fund.

4. HOLDING COMPANIES

The fourth type of institutional owners are holding companies. Such companies now exist in Yugoslavia and own shares in other enterprises. Many large conglomerate enterprises have been restructured into holding companies which own all or part of a number of "subsidiary" companies. Holding companies are legally the same as other companies except their only business is to own shares in other companies. In turn, the owners of the holding companies hold the shares issued by the holding companies.

This concept could be used to transfer ownership of enterprises to all citizens of Yugoslavia. Holding companies would be created and given shares in other Yugoslav enterprises. In turn the shares of the holding companies would be given free to the citizens of Yugoslavia without payment. Enterprises would pay dividends to the holding company which in turn would pay dividends to the citizens who own it.

Holding companies might appear to be little different from mutual funds. Though they are similar, the holding companies would be expected to be active owners while mutual funds tend to be passive owners who do not become involved in the management of an enterprise. (As discussed above, this traditional role of mutual funds has been changing somewhat in Western countries). Though this may appear to be a difference in name only, the use of the term "holding company" would emphasize the role of these institutions as active owners.

Though a mutual fund (as well as a pension fund) may elect members of the board of directors, a mutual fund would usually not become involved in the day-to-day management of an enterprise. In contrast, holding companies could become more involved. Managers of the holding company may be members of the board of directors of a subsidiary company and participate in the monthly meetings of the board. The holding

[34]Hanke (1991).

company may insist on receiving detailed monthly financial reports, approving major investments, and reviewing the strategic plans of the subsidiary company.

There is also traditionally a difference in the skills and training of managers of holding companies and managers of mutual funds. Managers of mutual funds tend to have financial backgrounds and do not have a great deal of experience in the management of enterprises. In contrast, managers of holding companies would have skills and training similar to the managers of the subsidiary companies and thus would be in a better position to monitor and oversee the performance of the subsidiaries. There is also likely to be considerable movement of managers between the holding company and the subsidiary companies so that managers of both types of enterprises are familiar with the operations of the other.

To assure that a holding company has the authority to be an active owner, it should own a large proportion of the shares in an enterprise. A holding company would clearly control a subsidiary company if the holding company owns more than 50 percent of the shares of the subsidiary. Holding companies can also control the enterprise with a smaller percentage if the other owners are numerous and each only have a small fraction of the shares.

D. THE PROPOSALS BY PROFESSORS SACHS AND HANKE

There appears to be a growing consensus among Western experts who have analyzed ownership restructuring in Eastern Europe that transferring ownership to one or more of the institutions discussed above is the best solution. Annex N discusses six proposals made by experts on privatization that primarily relay on transferring ownership of shares to these institutions.

Two of these proposals have been specifically developed for Yugoslavia. The first is by Professor Jeffrey Sachs of Harvard University in conjunction with David Lipton[35] This proposal was first developed for Poland. Professor Sachs later proposed a similar plan for Yugoslavia in meetings with Slovenian officials in April, 1991. Professor Sachs favors transferring shares to a variety of institutions as well as selling a portion of the shares.

The second proposal is by Professor Steve Hanke of The Johns Hopkins University.[36] Professor Hanke proposes transferring shares primarily to pension funds. These two proposals illustrate some of the issues in developing a plan to transfer ownership to institutions.

The proposal by Professor Sachs is to distribute the shares in socially-owned enterprises roughly according to the percentages in Table 2[37]. The transfer of shares to the pension funds, banks, and mutual funds would be without payment. Workers would be allowed to buy up to 15 percent of the shares at a discount.

Giving workers a right to buy shares at a discount could be justified on the grounds of fairness, the history of worker self management, and the precedent established in the existing Federal and Republic laws. This right should be limited, however, so as to permit outside investors to take control of the enterprise and eliminate the abuses of worker self-management.

The remaining 25 percent would be retained by the Republic's Development Fund until they can be sold to investors other than workers. The hope is that a single investor, perhaps a foreign company or another

[35] The most complete description of this proposal can be found in Lipton and Sachs (1990).

[36] Hanke (1991).

[37] These percentages are taken from the presentation by Professor Sachs in Slovenia but are similar to his proposal for Poland.

Yugoslav company, would wish to buy the shares held by the Fund and take an active interest in the management of the enterprise. This investor would be similar to the stable core investor in the French privatization program.

Table 2 Proposal by Professor Sachs

	PERCENT
Give Away to:	
Pension Funds	20
Mutual Funds	30
Banks	10
Sale to:	
Workers	15
Investors	25
TOTAL	100

In the meantime, Professor Sachs recommends that the Development Funds be active owners, in other words, monitor and oversee the performance of the enterprises and exercise their right to vote for members of the Board of Directors. This is in contrast to the current or proposed laws in some of the Republics where the Development Fund must be a passive owner and not participate in the management of an enterprise.

In contrast, Professor Hanke would transfer social capital only or primarily to pension funds unless the amount of social capital exceeded what was required to fully capitalize these funds. In this case, the remaining social capital could be used for other purposes such as helping to rehabilitate the banks. In effect, Professor Sachs prefers to use a mixture of the various options (sale, give away, transfer to institutions) while Professor Hanke would concentrate on just a single option (pension funds).

Professor Sachs is not entirely clear as to why he prefers this mixed approach. One reason given is that selling shares to workers at a discount would encourage their support for the program. A free gift of shares to the mutual funds would also encourage the support of all other citizens in addition to workers. By giving shares to the banks and pension funds, future governmental expenditures and thus taxes can be reduced which might win support from government leaders and politicians.

Another argument for the Sachs proposal is that having a number of owners of each enterprise instead of just one owner such as a pension fund might result in better corporate governance. If one owner is not able or willing to monitor and oversee the enterprise, another owner might be. Also placing all shares in the hands of just a few pension funds would give them a great deal of economic power which could be abused. With multiple owners, one owner can act as a check or balance on another owner.

Transferring ownership of all enterprises to a single type of institution, namely, pension funds, would be different from the pattern of ownership in Western countries. Though pension funds play an important role in most Western countries, they are not the only or even the dominant owner of enterprises. Private pension funds would be a new institution in Yugoslavia, and there is no experience in how they would operate in practice. Thus the Hanke proposal would be like putting all of one's eggs in a single basket.

If the Development Fund is successful in finding a buyer for 25 percent of the shares under the Sachs proposal, this would raise the problem of how to recycle the sale proceeds back to the enterprises so as not to reduce capital available for investment. It should be noted that a future core investor can always buy shares from an institutional owner and take control of an enterprise. There is no need for the government to retain ownership for this purpose.

Though it may be desirable for the Development Fund to be an active owner since this would improve corporate governance, there is also a substantial risk in this approach. Since the Development Fund is an agency of a Republic government, the government would still be the owner of a large share of each enterprise. The government may decide to use its ownership to require the enterprise to pursue political or social goals which could introduce all of the problems discussed above concerning government ownership and control of enterprises.

E. RECOMMENDATION

We favor the general approach to ownership restructuring found in both the Hanke and Sachs proposal, namely, the emphasis on transferring ownership to institutions. A third proposal, however, is likely to be better for Yugoslavia than either of these two. This proposal is offered with the hope that comments and suggestions will be received and the proposal can be further developed and refined. This proposal is summarized in Table 3.

Table 3 Recommended option for ownership restructuring.

	PERCENT
Distribution to:	
Pension Funds	45
Holding Companies	30
Banks	10
Workers	15
TOTAL	100

Shares would be transferred without payment to three institutions -- banks, pension funds, and holding companies. In addition, some shares (about 15 percent) would be sold at discount or given away to the workers.

1. DISTRIBUTION TO BANKS

In this proposal, roughly ten percent of the shares in each socially-owned enterprises would be distributed to a particular bank. This is based on the value of shares required to restore the average bank to solvency. In this way, the value of each bank's assets would be increased to a level roughly equal to its liabilities. The amount given to each bank would depend on the financial position of that bank. The average bank would find that roughly 40 percent of its assets are shares in enterprises.[38] The bank must actively monitor and oversee the performance of these enterprises in order to earn enough revenue to pay its depositors. Each enterprise would find that an owner of ten percent of its shares would be a single bank. This bank would be analogous to the "main" bank concept in Japan.

By law, Yugoslav banks may not have more than 20 percent of assets in the form of shares in enterprises. If this limit would be exceeded, this problem could be resolved in a number of ways. One way would be to give the banks a time limit, say 10 years, in which to sell the shares above the legal limit. Another way would be to make a debt-equity swap up the legal limit, and retain some loans in enterprises. Determining the best solution may have to wait for a more accurate estimation of the value of the social capital.

This, however, does not answer the question of who would own the banks. It is essential that they no longer be owned by the "founding" enterprises or controlled by the government. The best solution would be to give the shares of each bank to that bank's depositors. At least initially, these shares would have a low value. Note that the free gift of shares is not to be considered as a substitute for deposits with the bank. Customers should still expect to be able to withdraw their deposits.

The depositors have the greatest interest in assuring that the bank is well managed and profitable. If not, the depositors may lose their deposits with the bank. After this transformation, it may be desirable for the government not to insure bank deposits. Such insurance removes the obligation of the depositors to monitor and oversee the performance of the bank both as an owner and as a customer (depositor).

[38]The exact proportion of shares to be given to banks will have to be based on a more detailed examination of the financial situation of banks and a valuation of enterprise shares.

2. DISTRIBUTION TO HOLDING COMPANIES

Instead of leaving a large block of shares with the Development Funds for possible future sale as proposed by Professor Sachs, about 30 percent of the shares would be turned over to newly established holding companies. In turn, the shares in the holding companies would be distributed free to all citizens. Citizens would be free to buy additional shares from other citizens or to sell their shares. The profits earned by the holding companies would be distributed to the citizens who own shares in the holding companies. In this regard, the holding companies would be similar to the Wealth Management Funds to be introduced in Poland.

One weakness of such a free distribution of holding company shares to all citizens is that it could cause an increase in consumption and a reduction in savings. In this regard, this option has the same weakness as the free distribution of shares in the give-away option discussed previously. In the case of the holding companies, however, only 30 percent of the social capital would be distributed free to citizens as opposed to 100 percent in the case of the give-away option.

To increase the role of the holding companies as active owners, 30 percent of the shares in each enterprise would be given to a single holding company. In that way, each enterprise would be responsible for its performance primarily to that holding company. The holding company in cooperation with the "main" bank would be responsible for any restructuring required of the enterprise. The main bank would concentrate on financial restructuring of the enterprise while the holding company would concentrate on operational restructuring.

Just as it is important for the holding companies to be active owners of the enterprises, it is also important that the holding companies have active owners who will assure that the holding companies do a good job. In other words, the question of "corporate governance" of the holding companies themselves needs to be examined. When the shares of the holding companies are distributed to all of the citizens of Yugoslavia, the holding companies will have millions of small owners. How can these many small owners exert effective control over the board of directors and the managers of the holding companies and replace poor managers if necessary.

As with other large Western companies with thousands of owners, the owners of the holding companies can exercise control in a number of ways:

- The holding companies should be required to publish detailed financial statements showing its economic performance.

- The board of directors of each holding company will be elected at the annual meeting of all the shareholders. Because there will be thousands if not millions of shareholders of each holding company, the voting for the board of directors will primarily be by ballots sent to the shareholders in the mail. If the holding company is performing badly, the owners (the citizens of Yugoslavia) can vote to replace the board of directors.

- Because there will be a number of holding companies, the performance of one such company can be compared against the others. This makes it easier to identify those holding companies that are performing badly.

- The shares of the holding companies can be sold by their original owners. Thus a market for such shares will quickly develop and the price for shares will become common knowledge. If a particular holding company is performing badly, the market price for its shares will fall putting pressure on the board of directors and managers to improve performance.

- As the shares in each holding company are bought and sold, the shares may become more concentrated with few individuals owning larger blocks of shares. These individuals would be able to exercise greater control over the board of directors.

Another concern with the "corporate governance" of the holding companies is that the government may wish to direct and control their activities even though the state is not the owner. Many of the problems of state ownership discussed above would then be introduced. We think that it would be desirable for the government to establish by law these holding companies and to limit the role of the government in their operation.

The government would have to appoint the first board of directors of the holding companies because no other competent body is available to do this on behalf of the future owners. After this, however, the holding companies should be entirely private, and the government should have no influence or control over their operation. For example, at the next annual meeting of the holding company, the board of directors should be elected by the share owners rather than appointed by the government. This principle of no government involvement in the management of the holding companies should be set forth in the legislation establishing these holding companies.

The holding company should have a strong incentive to improve the operations and profitability of enterprises through a restructuring program. The functions of the restructuring agencies established in all of the Republics would largely be taken over by the holding companies. We would expect that the holding companies would hire the staff of the restructuring agencies and these agencies would be eliminated. One way of viewing the role of the holding companies is that they would become "private" restructuring agencies thus eliminating the need for government restructuring agencies.

The holding companies are likely to become major sources of new capital for the enterprises that they own and thus assist the enterprises with restructuring. The profitable enterprises will pay dividends to the holding companies. The holding companies can then choose to pay out the dividends to their owners (the citizens of Yugoslavia) or to reinvest this money back into the enterprises. The holding companies could reinvest this money by buying new shares in the enterprises or by loaning them the money. Large Western companies routinely decide whether to pay dividends to their shareholders or to reinvest the money in profitable activities. The holding companies will also have to make this decision. Initially, we would expect that the holding companies would not pay large dividends to their shareholders (the citizens of Yugoslavia) and would instead choose to reinvest the money to help the enterprises in Yugoslavia modernize and grow.

The holding companies may also be able to obtain new capital from other sources to assist the enterprises with restructuring. For example, the holding companies can borrow money themselves both from domestic and foreign sources. The holding company could then invest this money in the enterprises. Naturally, the holding company would want to make certain that any money it provides to an enterprise will be invested wisely and lead to an improvement in the profitability of the enterprise and not be used just to maintain worker incomes.

As discussed above, this is not to say that the government would no longer have a role in the restructuring of enterprises. The government could implement a restructuring program designed to assist the owners of the enterprises in improving their operations.

The holding company will need to hire foreign and domestic experts in all aspects of business management to help with the oversight of enterprises. In many respects, the holding company would be like a management consulting firm helping each of the enterprises to become more profitable. The holding company may have to assist in negotiations with banks or other creditors either to provide more financing or to renegotiate existing loans.

Shares of enterprises should not be transferred to a Development Fund under the control of the government. The Development Fund will either be a passive owner who does not monitor and oversee the management of an enterprise or an active owner who is itself likely to be under the direction and control of the government. The choice seems to be between no owner or the government as owner. Neither choice is attractive.

One objective of the holding company would be to find a foreign or domestic investor who may be a better owner of a particular enterprise than the holding company itself can be, for example, a foreign company in the same line of business. In other words, the holding company should always be willing to sell its 30 percent of the shares to a "core" investor if such an investor can be found.

The holding company would have a financial incentive to sell to such an investor. A core investor is likely to be willing to pay more for the Yugoslav enterprise than the holding company would receive in the form of future profits and dividends. Again this is because the core investor has the necessary expertise and a strategy to improve the operations of the enterprise. This is the kind of sound business decision that corporations in Western countries routinely make when they sell divisions of the company or subsidiary companies to another company with a better strategy to improve their profitability.

Thus the holding company should be willing to voluntarily perform the same function as Professor Sachs envisions for the Development Funds, namely, the sale of a block of shares to a core investor. There may be an argument, however, for the creation of an additional incentive for the holding company to sell its shares to a core investor.

The holding company might become complacent and not actively pursue this option even though it is in the best interest of the holding company. One possibility is to require each holding company to reduce its net assets by a fixed percentage each year, say ten percent, and pay the proceeds to the owners in the form of an extra dividend. The holding company would then have to sell some of its shares in enterprises to private investors. In this way, the holding company would wither away over a ten year period. The risk, however, is that such core investors may simply not arise. The best option for the Yugoslav economy may be for the holding company to continue for a long time because they are the best owners available.

Another possibility is for the government to maintain some residual control over the operations of the holding companies, for example, by owning some part of each holding company.[39] Admittedly, such holding companies would be new institutions in Yugoslavia and exactly how they might operate can not be known with certainly.

The risk, however, is that the government may take over control of the holding companies and in turn control the enterprises. In effect, the enterprises would be little different from government-owned or nationalized enterprises. Government has the ultimate authority over the operation of the holding companies through the power to pass laws and regulate their operations if it appears that the holding companies are not performing as anticipated. It is not necessary for the government to continue to own these holding companies in order to protect the national interest.

3. DISTRIBUTION TO PENSION FUNDS

The largest block of shares (about 45 percent) would be given to new private pension funds. In turn each employee would have the right to receive a "standard" pension from one of the funds. Once the shares were transferred, the funds would no longer be agencies of the government but would be controlled by their members.

[39] One option used by some Western countries to maintain limited government control over enterprises sold to the private sector is a "golden share." The government continues to own a special share in the enterprise that gives the government certain limited rights over the management of the enterprise. The founding articles or statute of the enterprise spell out the rights of the government as holder of the golden share.

The standard pension that an individual can expect to receive will depend on the value of the shares of the enterprises. We have not made an estimate of either the value of the shares or the pension level which could be supported by these shares. The pension level may be below the normal or usual pension expected by Yugoslav citizens. In this case, the government will have to continue with its own but smaller pension program to supplement that offered by the pension funds. The government pension would have to be paid for in the usual way through taxes.

Compared to the holding companies, the pension funds would tend to be passive owners. Their focus would be on the provision of pensions rather than actively managing and controlling enterprises. The funds would need assistance from foreign experts in the management of pension funds, for example, actuaries and portfolio managers. This is not to say, however, that the funds may not become involved if it appears that the other owners of an enterprise are not doing an adequate job. Legally, the pension funds would have the same ownership rights as any other owner.

4. DISTRIBUTION TO WORKERS

Finally, a block of fifteen percent of the shares could be sold at a discount or provided without charge to the workers in socially-owned enterprises. This would be in recognition of their rights inherited from the system of worker self-management. Giving shares to workers could be implemented in two alternative ways:

- give each worker shares only in his own enterprise; or
- give each worker a portfolio or mix of shares in many enterprises.

The first choice may be considered unfair since workers in a profitable enterprise would benefit while workers in loss-making enterprises would receive nothing of value. If a mix of shares is given to workers, the best approach would probably be to give them extra shares in the holding companies.

One difficult issue is the transition from the current Federal and Republic laws for those enterprises which have undergone transformation according to those laws. In order to avoid the problems of a mixed economy discussed above, transformation under the current laws should be replaced by the above proposal. In other words, any purchases by workers of internal shares under the existing Federal or Republic laws should be replaced by the distribution of the free shares according to the above proposal. Any payments for internal shares would be returned to the workers.

An argument could be made that workers are already receiving 45 percent of the shares indirectly since these shares are being used to capitalize the pension funds. Thus no further shares should be given without payment to workers. If this argument is accepted, workers instead could be offered the opportunity to buy 15 percent of the shares perhaps on the same conditions as offered by the existing Federal or Republic laws. This alternative would remove automatically the problem of transition between the existing laws and the proposal given here.

F. IMPLEMENTATION

The end result of this recommended option would be that a typical company would have the ownership structure shown in Table 4. The holding company and the main bank would play the dominant role in monitoring the performance of the enterprise. The balance of the shares would be split up among a number of pension plans who would more likely be passive investors who desire a diversified portfolio of shares in many enterprises. Finally the workers would own the balance of the shares.

The above proposal to restructure ownership will be a major undertaking. It will involve both the transfer of ownership of most enterprises and the creation of new institutional owners. If this proposal is adopted, a detailed plan for its implementation will have to be developed. The following provides an outline for such a plan showing the major steps that must be undertaken.

Table 4 Proposed ownership of a typical enterprise.

Distribution to:	PERCENT
Holding Company	30
Main Bank	10
Pension Fund No. 1	5
Pension Fund No. 2	5
Pension Fund No. 3	5
Pension Fund No. 4	5
Pension Fund No. 5	5
Pension Fund No. 6	5
Pension Fund No. 7	5
Pension Fund No. 8	5
Pension Fund No. 9	5
Workers	15
TOTAL	100

It must be recognized that the complete development of the new ownership structure will take some time to implement. However, we believe that ownership of the enterprises should be transferred immediately to at least some of the newly created institutional owners even though the new owners may not be fully prepared to take over ownership and to exercise their rights as owners.

Currently, most enterprises have no owners. The establishment of even the most rudimentary form of ownership by the new institutions would be an improvement over the current situation. As the new institutions develop procedures, hire the necessary staff, and gain experience, they can exercise more and more effective ownership over the enterprises. In the beginning, the new institutions may not be very effective owners, but they will be better than no owners at all.

The two institutions that could take over ownership immediately are the banks and the holding companies. The creation of the private pension funds, however, will take more time, and more study is needed as to how the new private pension system will be integrated with the government pension system. For this reason, we propose that the shares of enterprises ultimately to be transferred to the pension plans remain for the time being under the control of the holding companies. In effect, the holding companies would act as "trustees" for the shares allocated to the pension funds until the pension funds can be established and take over ownership of the shares.

Alternatively, the existing Development Funds established in each Republic could act as trustee and hold the shares allocated to the pension funds. In the meantime until the shares were actually transferred to the pension funds, the Development Funds could collect any dividends paid on these shares. The Development Funds could transfer these dividends to the government to be used to help pay for pensions.

It will also take some time to carry out the distribution of the shares of the holding companies to the general public. Administrative procedures would have to be developed for distributing the holding company shares, for example, developing a comprehensive list of the citizens entitled to receive shares and verifying that citizens do not receive more shares than they re entitled.

The creation of the holding companies, however, does not have to wait for the actual distribution of the holding company shares to Yugoslav citizens. Again we envision that the shares of the holding companies could be held by a board of trustees on behalf of their ultimate owners, the citizens of Yugoslavia, until the holding company shares can be physically distributed. The trustees would be prominent citizens of high reputation who could supervise the ultimate distribution of the shares to all citizens.

The two key steps in the creation of the new system of ownership are:

- legislation that requires enterprises to be converted into joint stock companies along western models and their shares distributed to the new institutional owners; and

- appointment of the boards of directors of each holding company.

The chairman and the other members of the board of directors of each holding company will play the central role in the development of the new ownership structure. Initially the government will have to appoint the boards of directors. A year later at the annual meetings of the shareholders of the holding companies, the shareholders can elect the same or a new board of directors.

The government's initial appointment of the board of directors is very important for the success or failure of the new system of ownership. From the beginning it is important to establish the principle that the holding companies are private companies and not governmental institutions or agencies. Though initially appointed by the government, the boards of directors are only responsible to the owners of the holding companies, in other words, the citizens of Yugoslavia, who are to be given shares in the new holding companies. The primary if not the only objective of the boards of directors should be to maximize the wealth or value of the shares held by the many owners of the holding companies. The boards can only do this by increasing the efficiency and profitability of the enterprises that are owned by the holding companies.

Once the boards of directors are appointed, they can begin to establish the structure of the holding companies. For example, the board of each holding company must appoint a general manager or chief executive to carry out the day to day management of the holding company. The board of directors would not be full time managers of the holding company. The board would only meet perhaps once a month to establish overall policies for the holding company. The new general manager would then proceed to create a management structure for the holding company and hire the necessary managers.

Another step that the boards of directors may wish to take shortly after the formation of the holding companies is to hire foreign management consultants to help with the management of the holding companies and the enterprises owned by the holding companies. In association with the other main owner, the banks, the holding companies will also have to appoint boards of directors for each of the enterprises owned by the holding company.

Thus it is important for the government to assure that the initial boards of directors are qualified to manage the holding companies and that they are independent of the government. To this end, the government should only appoint highly qualified businessmen (including foreign businessmen) to serve on the boards of directors. Appointing government ministers or officials to the boards serves no useful purpose and may cause a great deal of harm because the holding companies then begin to behave like government agencies rather than private companies.

To further limit the ability of the government to control or influence these new holding companies, it would be desirable for the legislation creating the holding companies to restrict the ability of government officials or ministers to influence or interfere with the activities of the holding companies. For example, such legislation could specify that the holding companies may not be subject to any rules or requirements that are not applied to all other private companies. Alternatively, the legislation could require the government to compensate a holding company if it were required by the government to undertake some activity that increased its costs or reduced its profits and that activity was not also required of all other private companies.

Initially, the holding companies may not be able to exercise much control over the many enterprises that they will own. The holding companies will undoubtedly be occupied with the establishment of the holding companies themselves. The simple fact that the holding companies now own the enterprises, however, will constrain and limit the authority of the managers of the individual enterprises to some extent. In particular, the managers can not sell the enterprise to a new owner unless the holding company as the existing owner approves the sale. The holding company can also take action against any managers of individual enterprises who sell or dispose of the assets of the enterprise if such a sale is not in the best interest of the owners. Ownership by the holding companies should reduce the ability of enterprise managers to take or dispose of assets for their own enrichment.

The success of the proposed ownership restructuring will largely depend on the ability to create holding companies that follow Western models of large private corporations. As in Western corporations, the primary objective of the holding companies should be to maximize profits and increase the value of the holding company shares held by the citizens of Yugoslavia. If the holding companies achieve this objective, there is little reason for the government to be involved in the operation of the holding companies, and in most cases such involvement is likely to be harmful.

G. UNRESOLVED ISSUES

Though the above proposal is likely to be the best approach to ownership restructuring for Yugoslavia, there are a number of issues that need further analysis. The first is how to integrate this proposal with the financial restructuring of enterprises and the rehabilitation of the banks. The analysis of this issue above (Section VII.C) suggests that ownership of insolvent enterprises should be turned over to banks in a "debt-equity" swap.

One alternative would be for the government to undertake a general financial restructuring of both enterprises and banks prior to ownership restructuring. A second alternative would be to turn over ownership to the new institutional owners and then let them manage the financial restructuring. The holding company and the "main" bank could organize a voluntary restructuring involving all of the creditors of the enterprise. The creditors would have to accept a scaling down of their loans to the enterprise if it can be made profitable. If a voluntary restructuring is not possible, the enterprise would have to be turned over to a bankruptcy court.

In all three alternatives, banks would need to be given additional assets so that they are returned to solvency and can repay their depositors. Our recommendation is that the banks be given shares in profitable enterprises to take the place of bad loans. The difficulty with this approach is that the amount of bad loans and the value of the shares in profitable enterprises would have to be estimated to assure that each bank received just the right value of shares. This could be an expensive and time consuming process. One alternative is for the government to give them bonds that would have to be paid for out of tax revenues.

Another issue with the recommended option is that it may restrict competition. The limited number of large holding companies may create an environment for formal and informal price fixing arrangements among various enterprises that will keep prices artificially high. In order to deter the holding companies from engaging in price fixing agreements or other cartel-like behavior, anti-monopoly laws may need to be enacted and rigorously enforced. Foreign enterprises, enterprises in other Republics, and new private enterprises, however, may create adequate competition if the Republic governments do not restrict their ability to compete.

Perhaps the most important issue in evaluating this proposal is whether the holding companies would be "good" owners of the enterprises and play an active role in assuring that they are as efficient and profitable as possible. The major objective of ownership restructuring is to improve "corporate governance" by putting in place active owners of enterprises following the model of Western economies and thus overcome the weaknesses of social ownership. Will the holding companies be such owners?

Holding companies may not be prove to be good owners of enterprises for two reasons. The first is that the creation of a limited number of powerful holding companies may invite undesirable government and political influence over their operation. Yugoslavia has a long tradition of informal government control over enterprises and institutions that were nominally independent. The end result may be government control of the holding companies and thus of the enterprises that is little different from state ownership.

As just one example, the holding companies should encourage enterprises to reduce the number of workers and eliminate the surplus labor that now exists in many enterprises. This, however, will result in substantial unemployment and may cause social unrest. The government may attempt to influence the holding companies to subsidize loss-making enterprises using revenues from the profitable enterprises and thus postpone the need to fire workers.

The second reason is that the holding companies may become large inefficient bureaucracies with little incentive to improve the efficiency of the enterprises which they own. The holding companies themselves will have thousands if not millions of owners. A common problem with large enterprises in Western countries which have many small owners is that the managers of such enterprises are largely free of control by the owners. It is argued that such enterprises are managed for the self interest of the managers rather than the owners. The many owners are not able to organize themselves to supervise and monitor effectively the managers. In other words, the "corporate governance" of the holding companies themselves may be very weak.

This risk of poor performance by the holding companies as owners of enterprises is the one major drawback of our proposal for ownership restructuring. As discussed above, the risk of poor performance can be reduced by various measures. Even though this system of ownership based on holding companies is not perfect, it must be compared to the alternatives. Ownership by institutions (banks, holding companies, and pension funds) is more likely to improve corporate governance than any of the alternatives examined.

H. CONCLUSION

Finally it must be noted that ownership restructuring should be designed as just one part of a broader program of market-oriented reform of the Yugoslav economy. Ownership restructuring will accomplish little if not accompanied by the other needed reforms. For example, a program for privatizing socially-owned flats and market reforms of the housing sector must be developed. Also this report has concentrated on the large socially-owned enterprises. A different privatization program is likely to be desirable for small enterprises and shops.

The option recommended above is not perfect and further analysis is likely to result in improvements, but a proposal along these general lines is best for Yugoslavia. Yugoslavia needs good owners of enterprises who have the authority and ability to monitor and oversee the performance of enterprises. Since such owners do not now exist in Yugoslavia and foreign owners are unlikely, the recommended option would create the owners in the form of holding companies, banks, and pension funds. Only by providing such owners for enterprises will their efficiency and profitability be improved thus leading to an improvement in the efficiency of the overall economy.

ANNEX A

ANNEX A: THE NEED FOR ECONOMIC REFORM

A. INTRODUCTION

Past institutional choices, in particular the concept of social ownership, makes it impossible to create an efficient market economy in Yugoslavia. The key components of a market based mechanism of resource allocation can not exist in the socialist organization of the economy. The other equally fundamental institutional choice, self-management, also blocks the building of a market economy. Indeed, centering on the most obvious incompatibilities, social ownership is incompatible with a capital market, whereas self-management is incompatible with a labor market.

1. SOCIAL OWNERSHIP IS AN OBSTACLE TO CREATING A CAPITAL MARKET

Capital markets exist to transfer ownership of real and financial capital. An efficient capital market means that capital can be transferred to another more valuable and productive use thus enhancing the overall productivity of the economy.

Social ownership of capital means that all economic agents have free and equal access to that resource. Transferring ownership of capital in such a regime is meaningless. The "holder" of a resource which is "socially-owned" cannot hope to sell it to another economic agent if the Constitution rules that everyone, including the would-be buyer, has the same rights to this resource. From the point of view of the buyer, why should he pay for the rights to which he is entitled anyway and more important which he must share with everyone else?

The impossibility of buying and selling applies to all resources included in the regime of social property. In practice, of course, there is buying and selling of socially-owned resources to a limited degree. That is only done, however, by deviating from the pure principles of social property. Bundles of special and exclusive rights to property or resources are devised in various ways to make buying and selling feasible. These rights are typically truncated and quite narrow, however, compared to the rights of ownership and do not provide a sound base for a decentralized, market economy.

A market economy requires - within certain limits established by law - full autonomy of basic decision-making units such as consumers, workers, owners of enterprises, and owners of natural resources. Social property does allow a certain degree of autonomy, but that is not sufficient for a full-fledged market economy. The bundle of rights over property and resources bestowed upon economic agents by social ownership is too narrow to make it possible to develop the contractual relationships needed in a market economy.

Closely associated with this limitation is a poor system for risk bearing. The Yugoslav decentralized decision-making system is peculiar in that it separates authority to decide from the responsibility for consequences. The risk of adverse consequences is not borne by those who take decisions.

Mobility of capital is an important prerequisite for economic efficiency in a market system. However, an economic system based on social property does not encourage mobility. The decision makers are not allowed to reap the benefits from finding superior ways of allocating social capital because collecting income generated by capital is not allowed.

The end result of all these limitations is a non-market arrangement for allocating capital resources. In particular, it is impossible to buy and sell social capital. No agent can be found to collect the sales proceeds.

As a result capital can not be moved from a low value to a higher value use. This is the fundamental deficiency of the structure of property rights embodied in the concept of social ownership.

2. SELF-MANAGEMENT IS AN OBSTACLE FOR CREATING A LABOR MARKET

The Yugoslav economic system also makes it impossible for the labor market to operate efficiently. This is the result of self-management by labor. Self-management can be defined as:

- an equal access of all citizens to social capital in the form of the right to work in socially-owned enterprises; and
- the right of workers to manage the enterprise in which they are employed.

One feature of self-management is that factor shares are lumped together. Labor tends to be awarded average rather than marginal product. In a well functioning or efficient market economy, the remuneration of labor would be equal for all workers with similar skills and equal to their marginal productivity. As average product varies across sectors and firms - due to differences in the technology of production - predictable and persistent differences in labor remuneration inevitable arise under self-management. The system produced large differences in the remuneration of the same resource which is fundamentally incompatible with an efficient allocation of resources.

The second feature of self-management which is incompatible with a market system is that enterprises "purchase" labor inputs at a much higher price than the price at which the unemployed would be ready to offer their services. In other words, wages tend to be higher than would be determined in a market economy by the force of supply and demand. That is a consequence of the monopoly of the employed over their work places. As a result, workers can appropriate to themselves the contribution of the other factors of production such as capital or land. This is despite the fact that these factors are not owned by them.

The third feature of self-management which is incompatible with a market system is that the same people are both the sellers and the buyers of the labor inputs. An efficient market for labor can not exist in which people sell labor services to themselves and in which the contribution of the socially-owned complementary factors such as capital or land can be appropriated to supplement their personal incomes.

The fourth feature is that self-managed enterprises are unwilling and unable to fire workers and thus to reduce the work force in the case of a business contraction. Thus surplus workers in one sector of the economy have no incentive to move to another sector where workers are needed. Such movement is essential for an efficient labor market.

The socialist principle of "remuneration according to labor" was the standard for setting worker incomes. This principle requires that any two equal amounts of "work done" - defined physically in terms of duration, intensity and qualification - should be equally remunerated. The implication of the principle and the test of its empirical implementation is the (approximate) equality of pay of people having the same skills and working in different branches of the economy.

Most importantly, this principle is a non-market standard. "Work done" is a physical quantity. It cannot have a clear economic meaning until and unless it is valued by the market. Two identical amounts of "work done", implying the same effort, skill level and everything else, could and will have a different economic value if provided in different parts of the economic system and under different circumstances.

True, the long-run market equilibrium will in theory equalize the value of any given type of labor in all alternative uses. But the economy is never in equilibrium. In a disequilibrium situation, the resources will be more highly valued in those alternatives where demand is high relative to supply. However, only the market can provide information about relative demand and supply. It is also important to recall that labor is highly heterogenous - no two workers are equal - and it is only the market that can generate the appropriate and economically efficient differences in the valuation of various shadings of labor.

Labor was also endowed with an entrepreneurial or ownership function under the system of self-management. The principal of remuneration according to work done, however, is inconsistent with this function. Because of its entrepreneurial function, labor becomes the claimant of the residual income of an enterprise. Hence, labor's total remuneration varies within very wide limits depending on the income of the enterprises.

Occasional attempts have been made by Marxist economists to repair this weakness. That was done by an attempt to draw a difference between labor income according to "work done" and according to the "result of work". Another way out was sought by forming a combined basis for remuneration consisting of labor and entrepreneurship, so that the entrepreneurial function was acknowledged as a legitimate component of labor income. That was, however, inconsistent with prevailing standards for remuneration. Such widely varying rewards for entrepreneurial contribution did not meet socialist standards.

More recently, self-management implied that social capital would be treated as a "free good". A free good is the one which can be used by anybody without payment of any compensation. Familiar examples are communal pastures and marine fisheries. When combined with free goods, the complementary resources are used in excessive amounts, which leads to their drastically diminished and even negative marginal products. Such an over usage puts the value generated by the resources for below their opportunity cost.

The earlier version of the system contained the so called "use price" of social ownership. In an economy operating in an uncertain and unpredictable environment, the use prices, however, cannot perform the assigned function of assuring efficient allocation of capital. The reason is that the return to capital is the natural and unavoidable absorber of random shocks and various consequences of business decisions both favorable and unfavorable. As a result, the rates of return on business investments vary greatly. Any preassigned, administratively fixed "use price" is to large for those investments which loose money and too small for those which are successful. The administrative obligation to manage capital embodied in the concept of self-management cannot substitute for the motivation to maximize wealth which is grounded in appropriately structured property rights. As a result, the use price was first widely differentiated - across sectors, regions, enterprises - and then abolished.

B. VALUATION OF RESOURCES

The absence of efficient markets for the factors of production does not mean that resources are not valued since factors have to be valued in some way as long as they are scarce. The lack of efficient markets, however, distorts Yugoslav resource valuation. Consequently, values differ widely according to their particular use which is incompatible with an efficient allocation of resources. These distortions in factor prices in turn distort product prices.

1. DISTORTIONS OF FACTOR PRICES

The extremely unequal valuation of labor is a matter of serious concern to Yugoslavia. Such inequality is seen by everybody as a violation of the fundamental principle of remuneration according to work done. In addition to being ethically unacceptable, this is economically inefficient as discussed above. The final result of the distorted valuation of labor is twofold:

- personal incomes are significantly above the levels which would be justified by availability of labor and by demand and supply; and
- the same kind of labor receives widely differing remuneration in different sectors and firms.

Consequently the existing economic system results in very unequal wage levels and is contrary to both economic efficiency and social justice.[1] Variations of incomes do not adequately reflect either the entrepreneurial contribution of labor under the system of self-management or the productive role of the labor input itself. Differences in income are too small in view of the first criterion and too big in view of the second. The end result is a severe distortion of relative incomes and their excessive level and rate of growth relative to labor's contribution to the social product.

Small wonder that much of the Yugoslav legislation in the economic field was devoted to the protection of social capital from those to whom it was entrusted for care and management. Examples include laws regulating accounting standards, limiting increases in personal incomes, limiting various business expenditures (such as per diem allowances or advertisement expenses), and prohibiting unsound and too risky loans by banks.

Legal controls on income are a substitute for the weak or nonexistent ownership structure for capital which could provide a natural defence against excessive increases in personal incomes. However, such controls are notoriously difficult to implement which is confirmed by experience. Any blanket prohibition of increases in income runs counter to the needs of economy to adjust to ever changing circumstances. All other ways of more selectively regulating increases in income are usually ineffectual. Working collectives show extraordinary ingenuity in bypassing legal controls and more frequently than not come out as winners in the complicated income distribution game played against the government. For example, workers defeated these controls by reclassifying the work force to higher skill levels and increasing various fringe benefits which cannot be controlled easily by administrative means.

A serious complications arises from the stop-go pattern of these controls on income. As soon as the controls are relaxed, the working collectives increase their personal incomes to the maximum extent possible. They do this in anticipation of future controls on increases in personal incomes.

Another factor is that workers tend to look at the highest income levels of other workers as a guide or justification for their own increases in income rather than lower paid workers. This is bound to exert a strong upward pressure on incomes.

Treating the existing capital as a free asset was encouraged by the drastic underpricing of financial capital. The "price" of capital is the "real" interest rate which is the actual interest rate charged less the inflation rate. The policy of cheap credit, i.e. low real interest rates, was one of the permanent features of Yugoslav development policy. In some periods rates of inflation rose unexpectedly high and much exceeded the nominal rates of interest. Real interest rates thus became very negative. According to one study, interest rates paid by banks to their depositors in the period 1976-84 varied between 5.48 and 8.11 percent. Interest rates received by banks from borrowers in the same period varied between 7.93 and 13.43 percent. The rate

[1] For an extensive empirical investigation of these discrepancies (which, among others, include the fact that at the industry level, remuneration for the same work varies to the extent of 1:2) see Popov (1972. p. 63-80) and Popov (1981. p. 49-71).

of inflation, however, varied between 9.8 and 57.0 percent resulting in a negative "real" rate of interest most of the time.[2]

Summing up, pricing of the factors of production has been just the opposite of what it should have been for an efficient economy. The abundant factor, labor, is systematically overpriced (and largely unemployed), whereas the scarce factor, capital, carries a low or even a negative price. Such factor prices distorted the choice of sectors and products, investment projects, the mix of production, imports for export and consumption and production technology. As all these distortions can be traced back to social ownership.

2. PRODUCT PRICING

Distortions in factor prices also induce distortions in product prices. In short, relative prices of labor-intensive products are too high, whereas the prices of the capital-intensive products are too low. In both cases, the prices are out of line with "opportunity cost". In other words, they do not provide correct information about alternative uses of the factors.

The economic data demonstrates these distorted prices. One study of ten large sectors gave the results shown in Table 5. Underpricing of capital led to low relative prices in capital-intensive sectors. Therefor these sectors have lower actual revenues than the "equilibrium" revenues which they would earn had the capital been priced efficiently. On the one hand, capital intensive sectors such as industry, agriculture, transport and communications, and housing have sub-normal prices and revenues (their indices are below 100 percent in Table 5). On the other hand, such labor-intensive sectors as the building industries, trade, and handicrafts have above normal prices and revenues (their indices exceed 100 percent in Table 5). Had the products been valued at their "equilibrium" prices, all sectors would have indices equal to 100.

Thus Yugoslavia has a highly distorted price structure for final products which gives faulty signals for the allocation of resources. This tends to perpetuate an existing distorted structure of production that is inconsistent with both market demand and social needs.

These distorted prices also distorted regional economic development. The overpricing of labor and the resulting overpricing of labor-intensive products made it possible for the developed regions to concentrate on the industries producing those products and prevented the underdeveloped regions (with abundant supplies of labor) from using their advantage in that respect. A more rational pricing system would have resulted in a far different pattern of regional production and location of industry than now exists.

C. SAVINGS POTENTIAL OF THE ECONOMY

The mechanism of income distribution and factor price formation described above produced a steady decline in business savings and a growing dependence on credits, loans, and other sources of finance external to the enterprises.[3] That is what is understood by the frequent allegation that "the accumulative and reproductive ability of the economy" is on the decline. There have been relatively long periods in which personal incomes grew much faster than labor productivity, causing a systematic movement of income towards labor and away from capital. The rapidity if this redistribution depends mainly on the legal controls imposed on wage and

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[2] See Radmilović (1985. p. 23).

[3] The "business savings" (also called "savings of the economy") means the internal savings (retained earnings) of enterprises in the social sector of employment, as opposed to other recognized "sectors" like households and the state.

Table 5 Economic position of major sectors of Yugoslav economy

Actual income shown as % of "equilibrium" income

Sectors	1975	1976	1977	1978	1979
Industry and mining	103.3	97.4	98.4	98.0	97.5
Agriculture and fisheries	99.2	103.5	97.6	88.6	91.1
Forestry	88.0	81.6	86.1	89.9	91.1
Water management	77.6	74.0	80.9	84.2	85.1
Building industries	102.9	105.6	104.9	107.5	-
Transport and communications	97.4	92.5	91.4	95.4	-
Trade	98.6	108.6	107.6	104.7	-
Catering and tourism	91.1	89.3	84.7	86.9	-
Handicrafts	108.2	109.0	107.1	107.3	-
Housing and communal services	94.7	93.0	93.9	93.8	-

Sources. Konzorcijum ekonomskih instituta za projekt "Privredni sistem SFRJ", in *Dohodak u jugoslovenskoj privredi* (Beograd, Institut ekonomskih nauka, 1981), pp. 96-128; and S. Babić: "Položaj u primarnoj raspodeli privrednih subjekata i namenska alokacija dohotka", in *Ekonomski anal,* 1980, No. 68-69. Cited in Todor Spariosu: *Metodologija izrade i ocena investicionih projekata u agroindustrijskom kompleksu,* M.A. Thesis, Beograd, Ekonomski fakultet, 1985, p. 73.

salary increases by the government.

The phenomenon of declining savings has had frequent and thorough empirical investigation. A survey by the Institute of Social Studies (Center for Economic Research) identified clear declining trends in several indicators of savings in the economy (see Table 6).[4] The slight increase in the rate of savings shown for 1981-83 is due to a biased estimate caused by an inventory evaluation effect.[5] This should not be viewed as a change in the downward trend.[6]

[4] See IDN-Centar za ekonomska istraživanja (1984).

[5] The inventory effect is a phenomenon well known to inflationary economics. As stock is revalued (at higher prices) after the lapse of a year, a large difference appears to exist between consecutive stock levels, apart from any change in real volume. These nominal inventory increases are treated as investments - a procedure which very much inflates both the investment level of the enterprise and its internal savings.

[6] For a more detailed explanation of this effect see: Madžar and Popov (1985. p. 102-111)

Insufficient savings makes it difficult to expand productive capacity and thus to bring about an increase in employment. Investment has to be financed out of the savings of households or borrowing from the rest of the world. Savings of households is limited. Servicing of foreign debt exhausts the economy's financial resources and, in the long run, restricts its expansion.

Table 6 Indicators of business saving.

	Net Savings as % of Income	Net Savings as % of Fixed Assets	Gross Savings as % of Fixed Assets
1966-1970	16.9	6.7	10.9
1971-1975	19.1	6.6	10.2
1976-1980	12.5	2.3	7.3
1981-1983	17.0	4.8	8.6

Source: Madžar and Popov (1985, pp. 102-111).

D. IMMOBILITY OF AVAILABLE RESOURCES

Serious constraints exist in the mobility of financial resources available for investment. Some constraints are due to attempts by Republic governments to maximize their share of financial resources and to prevent their own resources from going elsewhere. The result is that financial resources tend to stay in the Republics in which they have been created.

Similar constraints occur at the level of the enterprise. Investment by an enterprise in anything but its own expansion is unprofitable because the enterprise is not likely to earn an adequate return and runs a risk of losing the investment entirely under the system of social capital. Socialist principles discouraged paying income to capital or a return on a financial investment in another enterprise. The few pragmatic, makeshift arrangements by which these principles are circumvented do not suffice to induce firms to invest in plants operated by other collectives.

The lack of a capital market in Yugoslavia makes it almost impossible for an enterprise to invest temporarily free resources on a short-run basis and to earn a market rate of return. This situation forces enterprises to invest such resources in their own physical assets - and to do so quickly, long before the resources reach a respectable amount. Otherwise they will melt away because of inflation. The consequence is numerous small investments which are bound to be inefficient.

The establishment of enterprises or facilities in new locations is also restricted. Existing firms have no motivation to set up new plants over which they will eventually lose control once the newly established plant is manned. The collective of its personnel acquires full self-management rights, and the investor loses earnings, principal and control. This, more than anything else, demonstrates the far-reaching drawbacks of social ownership.

Inability to invest in other establishments forces firms to expand the range of their own products and to promote vertical integration. Thus the firms enter areas for which they do not have the requisite know-how or a comparative advantage.

Because of the insufficient mobility of funds available for investment, the existing structure tends to reproduce itself without regard to changing external circumstances and market forces. Employment creation is also reduced. A distorted economy loses some of its growth momentum, its savings potential tends to decline, its investment is unfavorably affected, and its ability to generate jobs is reduced. Lack of mobility also means that some investment opportunities will remain unexploited, and accordingly some high-quality projects, which would have provided new employment, will not come into existence.

E. SLOW RESPONSE OF ECONOMIC AGENTS

The slow response of those who make decisions is an additional problem with the system of self-management. The reasons why enterprise managers react slowly are twofold. First, the processes of collective decision-making are complicated and roundabout, and their slow pace is a well known fact. Second, there may be insufficient incentive for managers to react quickly to changes in circumstances.

1. ORGANIZATIONAL CAUSES OF SLOW MANAGEMENT RESPONSE

Under the system of self-management, there are too many people who have some say in business decisions, although they may have little interest in the issue or, in particular, in accepting the underlying risk. A decision sometimes has to go through a series of bodies each of which is entitled to discuss and to approve it. Misunderstanding, obstruction, and other complications have to be overcome by patient, persistent, and tactful action - which takes time. Enterprises consist of relatively small, economically independent units. Some major actions require the co-operation of several such units. Here again the long process of interest harmonization is difficult to avoid.

A fundamental economic unit in Yugoslavia, instituted in the 1974 Constitution was the Basic Organization of Associated Labor (BOAL). It was defined by law as competent for a very restricted range of activities. This restriction, in combination with inability and lack of motivation to create new firms, makes for a very rigid and inflexible adjustment to changing circumstances.

2. IMPLICATIONS OF EMPLOYMENT CONSTRAINT

A distinctive feature of the Yugoslav system is the well-known "no lay-off" constraint. Except in come exceptional circumstances (such as imprisonment for more than six months), a worker, once employed, acquires life-long job security.

In the case of a major technical innovation or a change in demand leading to the reduction of the number of workers required, the organization is (perhaps with assistance from the local authority) obliged to find a job for every redundant worker. If the need for labor is reduced, the usual outcome will be that the number of workers remains the same and the diminished amount of work is shared among them. Thus individuals will, on average, work less.

It is obvious that the "no lay-off" constraint introduces much additional rigidity into the economy. Varying the number of workers is a useful way of adjusting conditions in the short run. Inability to reduce the work force as demand conditions require, coupled with credit financing of unsalable output, creates a rigidity which is bound to have far-reaching effects on the pace and pattern of structural change. Declining sectors continue to produce output which can not be sold while growing sectors are unable to find the resources to meet an increase in demand.

Moreover, having surplus workers on the payroll may have an even worse effect than just sharing the reduced work load over too large a number of operations. Total production may actually be less than would be the case with fewer workers. In other words, the extra workers have a "negative marginal product".

Rigidity is largely responsible for the prevailing structural imbalances in the economy. Such imbalances are a formidable obstacle in the way of ownership restructuring. The existing production structure is unsustainable in a market economy and will be forced to change as soon as liberated market forces are allowed to play themselves out following the interaction between demand and supply.

F. LOSSES, INFLATION, AND LIQUIDITY

The end result of the distortions caused by the system of social capital are large enterprise losses, inflation, and lack of liquidity. Due to the absence of the appropriately structured property rights, personal incomes rise beyond any reasonable limits and erode the capital base of the economy. A powerful cost-push inflationary factor is thus built into the economy. Large business losses become inevitable.[7]

The no-lay-off constraint and downward rigidity of wages makes it impossible for enterprises to adjust labor costs in response to changes in output and revenues. The resulting losses have always threatened the Yugoslav economy, but in recent years they have rapidly consumed whatever social capital has been preserved. As A. Bajt shows, the losses are accommodated by various types of budget softening[8]. One way of compensating for the losses is a steady expansion of inter-firm credits and corresponding escalation of the "accounts payable". The other way is the uncontrolled expansion of bank credits. The credits are lightheartedly granted by the banks which are owned by their largest and least responsible debtors.

Bad credits have come to occupy a disturbingly large portion of the balance sheets of banks. When due for repayment, they are routinely rescheduled since the debtors are unable to repay them. The refinancing costs are excessively high, but the enterprises seem to be insensitive to these costs. After refinancing, the burden of debt is much bigger, so that both debtors and creditors come to understand that these debts will never be repaid. The increasingly contaminated balance sheet of the banks forces them to increase their lending rates, which cripples the remaining healthy enterprises in the economy. In fact, the banking system transforms itself into a huge redistributive mechanism which drains off resources from the still viable portion of the economy to nourish the growing number of loss makers who are about to strangle the economy as a whole.

Whatever new capital is poured into the enterprise spills quickly out as personal incomes for workers. Excessively high personal incomes drain the enterprise sector which, in turn, drains the banks. A general liquidity crisis develops. In particular, working capital is eroded and enterprises find themselves in the dangerous situation of not being able to continue production.

This is the point at which bank loans - the bulk of which appear to be bad - are likely to be monetized. The central banking system faces a difficult choice. It can stick to its stabilization goals and protect the national currency from inflation by not creating new money. In which case, many firms would stop producing and the economy would plummet. Alternatively the central bank can replenish the depleted working capital funds and thus accommodate steadily accelerating inflation.

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[7] To illustrate, average monthly social sector wages increased from $162 in 1988 to $316 in 1990 (the end of the year), of Petrović and Dragutinović. (1991), Klobuūar, J. (1991. p. 90). It is indicative that in the course of one single year average personal income jumped from $195 per month at the end of 1989 to the above mentioned $316 at the end of 1990. At the same time the amount of social sector's business losses are estimated to have reached at least $8 billion; cf. Sekretarijat za informacije SIV-a, *Smerom reforme*, (1991). In fact, the cited material (p. 13) indicates that the share of business losses in 1990 amounted to no less than 20.7 percent of the economy's income which is roughly equivalent to value added. Putting the estimate of income at modest $50 billion, the estimate of losses could be put at an impressive $10 billion!

[8] See Bajt (1989. p. 7-44).

The choice is determined by social and political pressures which favor accommodating inflation. Short-run improvements are purchased at the price of a much larger long-run decline. In the politically controlled systems, the medium and the long run are laid down on the altar of the present and sacrificed for the sake of political expediency.

The liquidity crisis is intensified by the accelerating capital flights into foreign currency. An important cause of the adverse capital flows is the increasing unrest and anxiety on the part of population caused by political instability. Since foreign exchange liabilities of the banking system significantly exceed the amount of reserves, the overall situation is potentially unstable and precarious. Loss of confidence can push the system into a foreign exchange crisis even through the reserve position is now the most favorable ever recorded.

The problem is compounded by the shaky liquidity position with respect to dinar balances. Namely, due to uncollectible loans the banks are unable to recover their dinar balances. As long as overdue loans are not repaid on time, the banks are short of dinars with which to buy foreign currency to replenish their depleted reserves. The inability to meet obligations towards the depositors sets off a further reduction in confidence and withdrawal of foreign exchange balances. A part of the funds withdrawn is deposited into foreign banks, but only tentative and unreliable estimates are available. Certainly, a good deal of the withdrawn deposits is held at home in the form of cash.

Another cause of the capital flight is the overvalued domestic currency and expectation of devaluation. The public recognizes that the existing exchange rate cannot last long being the only price not participating in the general inflationary upsurge. At the same time, the decline in the official foreign exchange reserves are closely watched by the public. The squeeze on liquidity, capital flight, business losses, and escalation of personal incomes produced a lasting calamitous effect on economic growth. The capital assets of the economy are becoming worn out and obsolete, technological improvements are almost absent, and the economy is losing its growth momentum.

These unfavorable trends are just a continuation of the declining tendencies initiated at the beginning of the eighties. The abrupt reduction in domestic absorption, which had to be instituted to enable the country to service its foreign debt, largely fell on investment rather than personal consumption. The short run bail-outs were obtained by putting a heavy mortgage on the nation's long-run growth prospects.

G. COUNTER-INFLATIONARY POLICIES

Inflation cannot continue unless the money stock is increased. The need to control the monetary printing press is voiced over and over again. For the reasons described above, this advice cannot easily be heeded in the Yugoslav economy. In an economy which is saddled with uncontrollable cost-push inflation due the basic structure of the economic system, the cost of fighting inflation by overly restrictive monetary policies is prohibitively high. Personal incomes have always been the highest priority item for the self-managed collectives which are the basic decision-making units in the Yugoslav economy. Incomes are not reduced as the money becomes scarce due to monetary restrictions. The difficulties are multiplied by the extreme rigidity of the production sector, caused by the inability of the firms to adjust the size of the work force. Hence the total amount of personal incomes becomes more and more of a financial burden on social enterprises as the funds become hard to acquire and the almost fixed labor costs press upon the diminished volume of production.

Monetary restrictions and rising outlays for personal incomes deplete working capital. This forces many enterprises to reduce or even halt production. The inevitable result is an overall decline of output and employment. Hence, the monetary cure for inflation has unacceptably high political and social costs.

Monetary policy, to be acceptable, has to be aided by other policies. These policies must prevent increases in labor costs. If that were possible, monetary policy could be used to improve the liquidity of the economy and to bolster production, whereas other policies would be there to prevent the new money pouring out as personal incomes.

The trouble is that such complementary policies cannot be relied upon. The firms don't care much about costs, especially payments to workers. Taxing incomes heavily just accelerates the depletion of working capital. The only way out is the direct legal control of personal incomes (and associated outlays), which has usually proven to be ineffective. The only reliable policy is the outright prohibition of all increases in personal incomes, which is politically very unpopular. That policy was one of the pillars of the most recent Yugoslav stabilization program, and it foundered because of its political consequences. The most destructive among these is the refusal of the Republics to abide by the Federal law and their attempt to develop their own competing legal frameworks and policies.

H. CONCLUSION

In conclusion the economy is burdened with fundamental and far-reaching institutional deficiencies associated with social ownership. Such deficiencies cannot be counteracted by economic policies. At best, they only can be ameliorated. Perilous ailments calls for radical therapy. Institutional defects can only be done away with by institutional reconstruction.

The weaknesses of the ill-defined and badly structured social ownership have been presented in some detail. In comparison, how would the economy perform if there had been in place a standard, fully defined, legally enforced, and market oriented structure of ownership rights. Most importantly, the capital resources would have acquired a market based, economically efficient valuation. Since valuation is relative, this implies that resources other than capital would also have been appropriately valued. The end result of a more reasonable valuation would be a more efficient allocation of available resources. That, among other things, means a higher social product from the same resources. In addition to this improvement in static efficiency, there would have been an improvement in dynamic efficiency. Out of a larger product, a larger economic surplus (savings) can be extracted. Enhanced savings implies higher investment and more rapid growth in the long run.

More rapid growth would also be facilitated by improved income distribution which would have resulted from clear and orderly ownership relations. Such an arrangement would to a large extent secure an automatic control of income formation, which is inherent in the market mechanism. That, too, would, contribute both to a more reasonable valuation of labor resources and to an increase in savings.

Higher investment, higher growth, and an improved allocation of resources would have added significantly to the solution of the unemployment problem. In particular, demand for labor would have increased much more rapidly. Also additional employment would have resulted from enhanced inter-sectoral and regional mobility.

Lastly, an improved ownership structure would have made economic agents more motivated and more responsive to changing external circumstances. This has two components. Firstly, the price structure would have been more appropriate and the responses to these prices would be socially more beneficial. Secondly, the agents would have an incentive to react much more quickly. Both would make it possible to exercise a modern style, market-attuned economic policy. That, in turn, would have reduced the arbitrary and mostly disastrous administrative interventions in the economy.

ANNEX B

ANNEX B: CORPORATE FINANCE AND GOVERNANCE IN MARKET ECONOMIES

A. THE CORPORATION

The basic forms of business organization in modern market economies can be broken down into three general types: single proprietorships, partnerships, and corporations (limited liability companies). Although the number of corporations is only a small share of the total number of enterprises (around 20 percent of around 17 million businesses in the US in the late 1980s, for example) they occupy the strategically dominant position in value, economic power, payroll and employment size, and revenues throughout the market economies.

The corporation is a legal entity. It is owned by its stockholders who elect a board of directors that appoints a professional management team to run the corporation. The major advantages of the corporation are limited liability (the stockholders are not personally liable for the debts of the corporation), the possibility of changing management, if necessary, and in having more options at their disposal for raising capital. The major disadvantage of the corporate form is "double taxation" in some countries. A corporate income tax is levied on corporate income before dividends are paid and then a personal income tax is levied on dividends after they are paid to share holders. Corporations can be either private or public, the difference being that public corporations are listed on the stock exchanges.

B. SOURCES OF FINANCE

The sources of corporate finance can be classified into internal and external. Internal funds come from retained profits and depreciation. Depreciation though considered as an expense in calculating profits is a source of funds for investment. External finance comes from lenders and investors.

The investors are the buyers of various financial instruments which the corporation issues. These can be either stock (or shares) where the investor's reward comes in the form of dividends (whose size is determined at regular intervals by the company), or debt instruments which give investors a pre-determined rate of return. Debt instruments come in many forms. They can have a long maturity of several years (bonds) or a short maturity of several months (commercial paper). Both can have either fixed or floating interest rates. In addition, there are numerous hybrid or combination securities, combining the features of bonds and stock. Thus preferred stocks of various kinds (cumulative, convertible etc.) can have a fixed yield like a bond, but dividends can go unpaid without triggering bankruptcy. A major new hybrid that has become popular recently is an "option". This represents the right to buy, for example, a share in a company at a specified price within a specified period of time.

Lenders mostly consist of banks which are a traditional source of external finance. However, suppliers and other companies can also be a significant source of credit, for example, "accounts payable".

The single most important source of finance are internal sources. (see Table 7 for data on the USA and Japan). This is true of the corporate sector in all the developed countries though less so for Japan in the past. The figures for the major Western European countries also show a predominance of internal finance over the years.[1]

The second largest source of corporate finance over the rears have been private sector loans, meaning basically banks. In 1984 almost 80 percent of Japanese and German companies external cash came from

[1] See Maycock and Gardner (1976).

ANNEX B

Table 7 Sources of corporate finance of the non-financial sector, average for 1967-1983 period.

	USA	Japan
Internal sources	66.6	49.5
Private sector loans	15.5	40.1
Corporate bonds	10.9	1.8
Equity	3.5	3.4

Sources: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, various years, The Bank of Japan, Economic Statistics Annual, various issues. The figures do not add up to 100% leaving out other minor sources.)

banks, while the figure for the US was around 40 percent and for Britain 55 percent.[2]

Historically, stock markets have played a more important role in the US and the UK in terms of corporate finance than in the other European market economies and Japan. The Anglo-Saxon tradition relies on equity capital, strong share-holders, relatively open capital markets, and an arm's-length relationship between banks and industry. At the opposite end of the pole is Germany whose corporate sector relies on loan finance and strong links between banks and industry.

It should be kept in mind, however, that historically banks in the US did play a large role in assisting the formation of America's big industrial groups. They operated as "universal banks" and maintained considerable influence well into the twentieth century. The Glass-Steagall Act of 1935, however, rigidly divided commercial banking, investment banking and brokerage both from each other and all other nonfinancial operations. It may not be the case that this was justified in terms of greater efficiency.

The largest changes in corporate finance have occurred in Japan. As recently as 1975, Japanese companies were obtaining 70 percent of their financing from outside sources, mostly from banks. By 1983, the figures were exactly reversed with internal sources going up to nearly 70 percent. That same year companies in Britain got 85 percent of their funds from internal sources, in the US the figure was 76 percent, and in Germany 75 percent. The famous distinction between bank-dependent industry and financial market industries may be changing for good, especially in Japan.[3]

Beginning around 1984, the large Japanese corporations switched away from the banks as their main source of external finance and went into bonds and equity. The ratio of debt to total assets had fallen below 30 percent. In the 1960's and 1970's it ranged between 40-50 percent.[4] The crash of the Tokyo stock market in 1990 will probably slow this trend, but it is not probable that it will totally reverse it. At the other end of the spectrum, US corporations have increased their debt financing in the same period primarily due to the

[2] See *Economist* (1986).

[3] See *Economist* (1986).

[4] See *Economist* (1991a).

leveraged buy-outs of the last decade and the rise of the high-risk (junk) bond markets. Germany has kept its own tradition of basically relying on the banks as the chief source of corporate finance.

Long term trends in the structure of ownership, the role of banks, capital markets and institutional investors are all related to the level of corporate performance and governance.

C. OWNERSHIP

The number of share owners is not the best of indicators and the exact numbers are not easy to determine. Suffice it to say, that the recent trends have been towards more widespread ownership in terms of the number of individuals or households that actually own shares. By 1988 in the UK, 21 percent of the population owned shares, compared to 17.3 percent in France and 7.4 percent in Germany.[5] This type of indicator does not, however, mean much, due to the fact that only a fraction of the population represent in-depth investors owning a large portfolio.

Indeed, the most pronounced trend has been a rise in share holdings by mutual funds and pension funds over the last decades. This trend was most prominent in those developed market economies in which the stock and capital markets play a larger role compared to banks. Pension-funds share holdings as a percentage of total value of shares listed have risen from somewhere under 10 percent in the early 1960's to around 30 percent by the end of 1988 in both the UK and the US. While in 1950 more than half the shares on the New York stock market and in London were owned by individuals, a survey showed that London's figure had fallen to 21.3 percent by 1989.[6] France and Germany have also followed this trend. In France, the net assets of mutual funds doubled between 1985 and 1988 growing to 200 billion ecus.[7]

Banks continue to be large owners of enterprises in both Germany and Japan. In Japan the "keirtsu" is a loose association of corporations usually headed by a "main" bank which holds significant shares in these corporations. Furthermore, the keirtsu have their own trading companies which play leading roles. The term general trading company is used to describe the Big Nine companies which are also the largest share-holders in close to 1,500 companies. This is the case because holding companies are illegal. Within a keiretsu, 10-30 percent of the shares of any given firm are owned by other group members. The banks play a major role but are limited to 10 percent by the Anti-Monopoly Law. In Germany, bank ownership is limited to 25 percent by law.[8] However, rules in decision-making on corporate issues make this a very important ownership share. It should be kept in mind that in 1983 just 11 percent of outstanding securities were equities in Germany versus. nearly half in the US and 60 percent in the UK, giving banks a major influence.

In recent years, ESOPs (Employee Stock Ownership Plans) have also contributed to widespread ownership. Since the 1970's when they were first adopted in the US, there has been a large increase with over 10 million people being involved in schemes of this type. Employee participation along the ESOP line and other profit sharing schemes have been spreading throughout Europe as well. Employee owned capital in Germany has risen from 2.3 billion DM in 1976 to around 15 billion DM in 1990, with some kind of employee participation

[5] See *Economist* (1989).

[6] See *Economist* (1991a).

[7] See *Economist* (1989).

[8] See Carson (1990. p. 453).

in capital encompassing 1,600 companies. Employee share options have been less popular in France and the UK compared to other participation schemes.[9]

It should be kept in mind that in recent years, there has been a retirement of existing equity in the US and the UK, overshadowing the issue of new shares. This has been the result of mergers and takeovers, as well as repurchase programs. The underlying reason is the reluctance of shareowners to dilute their ownership and control by issuing stock, thus also avoiding disclosure rules about their operations. These developments resulted in the growing importance of corporate debt.

D. OWNERSHIP AND CONTROL

Over the years, starting with the famous study by Berle and Means, the conventional wisdom is that ownership and control are divorced. This has inspired many studies and alternative theories of management behavior, power, and control in the modern corporations.[10]

Obviously, there is a case to be made that ownership is divorced from control and corporate governance. The well known economist, John Kenneth Galbraith developed the notion of the "technostructure" i.e. complex web of highly qualified managers, planners, research and development scientists, and the like. According to this view, such individuals seek autonomy in order to take the enlightened long-term view of corporate interests. The managers are, therefore, mostly concerned with long-term growth, long-range profits, technical perfection, as opposed to short-run objectives.

This view is based on oversimplified assumptions. As one in-depth study of corporate control and corporate power in the US concludes[11]

> "In fact, organizational changes, continued technical progress and competitive pressures, and the "brooding omnipresence" of ownership interests, operating through both market and non-market forces, have led to an internalization of profitable growth criteria in corporate psyches and the rules of large managerial corporations" .

The same study, also concludes that although direct and decisive control has been on the decline, that

> "shared power in the sense of important minority and/or constraining influence on decision making is applicable in perhaps as many as a fifth of the large companies. The financial view of sound policy is pressed home to managers by a still wider array of banker representatives on boards and personal, business, and market influences of financial institutions as creditors and owners of stock".

It should be kept in mind that the mentioned study covers the 1900-1975 period and analyses the largest nonfinancial corporations in the US.

In the Anglo-Saxon corporate world in which capital markets play a more important role than in other developed market economies, events show that there is a market for corporate control. The trend of

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[9] See Uvalić (1990).

[10] See Berle and Means (1932).

[11] Herman (198l. p. 112, 161).

leveraged buy-outs, management buy-outs and buy-ins, mergers and the like has shown that entrenched management is far from secure and autonomous. In fact some have identified this as the "end of the public corporation" in the sense that many of these companies were in fact "going private" through takeovers and buy-outs of various kinds.[12]

In other words, the large pension and mutual funds that have been growing in importance have switched from the role of passive to active investors. Instead of trading in a large number of small liquid positions, the funds have reoriented there philosophy to taking a smaller number of large illiquid positions. In this way, they can more actively participate in the control of management and assets.

The 1980s wave of takeovers and leveraged buy-outs (where debt is raised through the high-yield, high-risk bond market in order to buy a company, and at the same time, using the target of the acquisition as collateral) differs from other waves of mergers and takeovers in US history. The takeovers and mergers of the early 1900's where trying to limit competition thus hoping to raise cash-flow. In the 1960's the buyers of companies where buying firms and creating conglomerates in order to diversify risk and relying on new management techniques to make them efficient. In the 1980's, takeovers were engineered with the intention of breaking up these conglomerates and raising efficiency through giving managers better incentives and controls and further using tax-breaks for debt interest payments in restructuring the companies and their cash-flows. The 1980's wave has raised the issue of corporate debt and problems associated with it like large-scale default in case of economic downturns. Suffice it to say, we may be witnessing the end of this trend with 1989 being the peak year. In the 1984-1990 period, leveraged buy-outs accounted for $216 billion worth of deals in the US.

Management buy-outs (the existing management takes over a company) as well as buy-ins (outside management moves in to buy a company) have been an important part of this process. In 1989, $23 billion worth of buy-outs where completed in the US while $17 billion worth were completed in Europe. Again, the UK belonging to the strong financial market tradition accounted for two thirds of these. However, in the first half of 1990 over half of the big management buy-outs occurred in continental Europe. It is too early to tell whether or not this kind of trend will continue, but it does show that certain US patterns might be evolving with the rise of capital markets.[13]

The rise of leveraged buy-outs and buy-ins is significant in the sense that it is calculated to overcome the divorce of ownership and control and upgrade management through incentive schemes. Leverage buy-outs are more decentralized in terms of organization and management. They rely on incentives, and ownership often acquires the characteristics of a partnership. In other words, bonuses for more managers are tied more closely to cash flow and debt retirement and to divisional performance. A study by Steve Kaplan, which included all public-company buy-outs from 1979-1985 with a purchase price of at least $50 million, shows that business-unit chiefs hold a median 6.4 percent equity position in their unit. The median public company chief executive officer holds only 0.25 percent of the company's equity. This shows a trend to bring ownership and control closer together.[14]

This has prompted some observers to conclude that the new evolving system of US corporate governance resembles the keiretsu business groups of the postwar Japanese system. It may be too early to reach such a

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[12] Jensen (1989).

[13] See: *Economist* (1991a).

[14] See Jensen (1989).

conclusion, however. Ironically, Japanese companies seem to be moving away from that system and may be beginning to resemble US corporations of 15 years ago. That conclusion, may also be premature.

Historically, as opposed to the Anglo-Saxon tradition in which ownership and capital markets have played the major role in ensuring corporate governance with little bank control in the post-war period, Japan and Germany are the obvious example of bank-monitoring of corporate performance. The pre-war tradition in these two countries has continued for the larger part of the post-war period. The recent changes in Japan, however, have not been matched in Germany.

In both countries, the Allies started off with stringent anti-monopoly laws quickly relaxing them as the cold war emerged as the dominant political reality of the post-war decades. The banks reemerged in Germany in the 1950s. In Japan the financial institutions were exempt from anti-monopoly laws. The result was that banks had a major influence on the companies as major lenders, stock owners (although there are limits in terms of percentages), and representation on boards of directors. In the German case, banks also controlled the firm's access to other forms of capital thanks to their investment banking capacity.

The major difference between the two countries is that large German enterprises have at least two large and competing banks as stockholders compared to the single "main" bank in Japan. Furthermore, other banks in Germany may have influence since they can use proxy votes on stock deposited with them by the public. This practice is known as Depotstimmrecht. In this way, banks are prevented from abusing their position against the stockholders interests, for example, by charging high interest rates. According to a report by the Federal Monopolies Commission, banks hold 145 seats on the supervisory boards of the 100 largest corporations (10 percent of the total number of seats). Of these, 65 percent belong to the Big Three banks).[15]

In Japan, as already noted, concentration reemerged as the keiretsu replaced the big pre-war zaibatsu concerns. The keiretsu are loose groups of companies that try to include at least one large firm in every industry. The main keiretsu bank usually owns a significant amount of stock in all corporations in the keiretsu group. This leads to claims that the bank extracts monopoly rents from the other stockholders by paying off both management and workers both through pay and lifetime employment.[16] Others have tended to see the role of the "main" keiretsu bank as playing the role of the "non-existent" capital market and a monitoring agent. In other words, the bank plays the role of gathering information and intervention in corporate governance whenever there is a perceived need to do so.

Furthermore, the bank may appear to be a residual risk bearer in the sense that it usually takes on a larger burden than would be expected in situations where companies encounter difficulties. This may be done for several reasons, one of the most important being that it sends signals to other banks and equity owners that the firm has potential and is likely to survive. This could also be the reason that it charges higher interest rates to the client firm.[17] In 1980, for example the main bank ranked as one of the top three stockholders in over 50 percent of the listed firms.

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[15] See Carson (1990. p. 630).

[16] See Nareyanan (1989).

[17] See Sheard (1989).

E. POSSIBLE LESSONS

Some of the possible lessons that could be learned from problems associated with corporate governance in developed Western economies are as follows:

1. Internal financing as the single most important source of corporate finance should be seen in perspective. Reliance in this source of finance may free managers from outside control. The major reason for this source of finance may lie with the tax system. Furthermore, in spite of huge internal resources, external sources from capital markets or competing banks have played the key role in the control of management.

2. In all cases, banks have played an extremely important role in creating and restructuring industry. The capital markets have played a more important role in the Anglo-Saxon economies, both in generating capital for corporate finance (e.g. the US around the turn of the century) and later to provide information about companies.

3. The relatively large number of stockholders in some countries may not mean much. The large numbers in England and France in the 1980's are due to large scale privatization schemes. Institutional investors are on the rise, and this is a consistent pattern.

4. Corporate governance everywhere is a problem caused by dispersed ownership. This enables management to pursue its own goals and divorces ownership from control. The recent takeovers in the US and the UK were usually undertaken to address this problem. In such takeovers, managers often become more like owners. Takeovers and management buy-outs seem to be spreading to Europe as well, where pension funds and other institutional investment may be on the rise.

5. The German tradition of close monitoring of corporations by competing banks with large stakes in the concerns has been preserved. This seems to be a convenient way of handling corporate governance in countries where capital markets play a minor role.

6. The Japanese tradition of "main" bank control over companies may be changing for good. This tradition consisted of banks playing the monitoring and interventionist role in corporate governance.

ANNEX C

ANNEX C: SOURCES OF CAPITAL TO BUY SOCIALLY-OWNED ENTERPRISES

A. THE NET WORTH OF THE YUGOSLAV ECONOMY

In order to evaluate the feasibility of selling socially-owned enterprises to private investors, it is necessary to compare the amount of private financial assets with the value or net worth of these enterprises. The proper estimate of net worth requires a case by case evaluation of all large-scale social enterprises. This is a large task since there are 2,458 such enterprises[1]. An alternative estimate is the "book value" of the enterprises contained in their balance sheets, which they regularly report to the Social Auditing Service.

The book value data may not be a good estimate of "true market value" of an enterprise in socialist economies. Estimates of book value should be considered as only a first approximation to the market value.

The government's stabilization program successfully brought down hyperinflation to a moderate level in 1990. This macroeconomic achievement resulted in more accurate reported balance sheets than was the case previously. The exchange rate was also stable during the whole year[2].

Table 8 Balance sheet of the social sector in the Yugoslav economy in 1990 (billion).

ASSETS	USA $	LIABILITIES	USA $
Fixed assets	144.669	Equity capital	128.049
Inventories	28.322	Long-term liabilities	17.949
Accounts receivable	50.535	Current liabilities	81.166
Cash	3.638	Off balance sheet items	13.593
Off balance sheet items	13.593		
Total assets	240.757	Total liabilities	240.757

Source: Savezni zavod za društveno planiranje (1991)

The consolidated balance sheet of the social sector enterprises is reported in Table 8. The social equity capital is estimated to be $128 billion. On the one hand, the value of fixed assets would be higher if land, buildings, forests, and other intangible assets were properly evaluated. On the other hand, the stock of accumulated inventories is overvalued, since a substantial part can not be sold at recorded prices, and the accounts receivable include some nonperfoming trade loans. The net effect of these underestimates and overestimates probably does not much change the estimated value of total equity capital. Based on a GDP

[1] A large-scale enterprise employs more then 250 persons, annually has a value-added greater then the equivalent value of 40,000 average gross wages in the economy or has a book-value of its assets greater than 30,000 average gross wages in the economy.

[2] It is assumed that the exchange rate is 12 dinars to the dollar.

estimate in 1990 of $65 billion, the fixed capital to GDP ratio is 2.2 which is reasonable for the Yugoslav economy given its level of development and industrialization.

The question is whether there are sufficient sources of private capital to purchase the $128 billion in net worth of the socially-owned assets? The following sections analyze these sources of capital.

B. SOURCES OF INVESTMENT CAPITAL

It is useful to divide investment capital into that part denominated in dinars and that denominated in foreign currency. The reason is that sale proceeds received in foreign exchange should be used primarily for retiring the foreign exchange debts. Sale proceeds received in dinars should be used in a different way.

The foreign debts are held by the rest of the world and by domestic residents. Foreign creditors and domestic residents hold financial claims denominated in foreign currency that are potential liabilities of the state. Yugoslav enterprises have already defaulted on foreign loans, which had been publicly guaranteed by the state.

C. FOREIGN INVESTORS

The equity capital of social enterprises could be sold to foreign investors. It is hard to estimate the potential amount of such foreign investment. There are two main obstacles which spoil the prospects of any massive capital inflow:

- political and economic instability, and
- disputes over the value of the social capital.

If these barriers could be overcome, the selling of social enterprises to foreign buyers would have both positive and negative effects from the macroeconomic point of view.

On the positive side, capital inflow will increase the supply of foreign currency, which is presently very limited due to a large deficit on the current account and will help to build up official reserves. This in turn will also allow an increase in imports and relax constraints on domestic production caused by shortages of imported raw materials. This will result in higher domestic production, additional exports, and less pressure on domestic prices.

On the negative side, foreign exchange might be used to encourage the import of consumers goods. In that case, current expenditures will be financed by the sale of social capital, which will ruin the national wealth in the long-run. Under the system of a fixed exchange rates, any increase in official reserves is likely to increase the supply of primary money with inflationary effects on all current transactions.

A potential use of sale proceeds to reduce taxes or to increase government services would be undesirable. It will have the same macroeconomic shortcomings as any other use of social capital to finance current expenditures.

From a macroeconomic point of view, proceeds from the sale of social assets to foreign investors should be used to repay foreign debts. A problem will arise, however, if these proceeds are greater then the foreign debt. At present, this is not likely, since only a moderate amount of foreign purchases could be reasonably expected.

What might be more likely is a debt-equity swap. In this way, a foreign lender to an enterprise would receive equity in the enterprise in exchange for canceling the loan. This would improve corporate governance without any negative macroeconomic side effects. Debt-equity swaps will not raise the risk of investment since it is already built into the financial investment. Due to harsh constraints on the balance of payments, prospects for normal debt servicing are not promising, and foreign creditors may try to sell some of their loans under market conditions. These conditions are favorable for new investors since a market price of Yugoslav loans fell recently by 40 percent.

The debt to equity ratio is rather low in Yugoslav enterprises. The outstanding amount of foreign loans to social enterprises are reported in Table 9. Such loans amount to only 7.5 percent of the estimated total net worth of social enterprises. Thus there is plenty of room for all foreign loans to be exchanged for equity.

A debt-equity swap would incorporate foreign investors into the Yugoslav economy. These investors could provide channels for new foreign investments.

Table 9 Foreign loans advanced to social firms (billion)

	USA $
Long-term loans	8.455
Short-term loans	0.313
Total liabilities	8.768

Source: Savezni za društveno planiranje (1991)

D. THE PUBLIC DEBT

Before analyzing other sources of foreign investments and the uses of sale proceeds, it is necessary to clarify the concept of the Yugoslav public debt. Sale proceeds should be recycled back to the private sector for investment instead of using them to finance additional (private or public) consumption. This could be done by using the sale proceeds to retire government debt held by private investors.

The problem arises, however, since the private sector does not hold government debt in the usual sense of the word. The private sector holds cash, checking, and savings accounts with commercial banks (denominated both in local currency and in foreign exchange), which are independent entities from the state sector. Ignoring the small amount of public loans, the only liabilities of the state are treasury bills issued by the Federal Government and held by the National Bank of Yugoslavia (NBY).

The NBY has accepted some foreign loans on behalf of the Federal Government and bought some other foreign exchange loans from heavily indebted domestic enterprises and banks. Through the process of foreign debt rescheduling, the NBY also became the guarantor of all outstanding private loans made by foreign lenders to Yugoslav enterprises. As a result, the NBY had to take steps to assure that there were sufficient official reserves of foreign exchange to back up this guarantee. The NBY required commercial banks to transfer all foreign exchange deposits of households to the NBY, which in turn granted them dinars advances as a part of the base money.

Foreign currency deposits are similar to fully indexed financial assets. In other words, their value is protected against domestic inflation. This is in contrast to the position of domestic financial assets which are typically revalued at a rate much lower then the rate of inflation. Inflation and devaluation of the exchange rate, therefore, caused huge losses for the NBY and commercial banks which had received these foreign exchange deposits. These foreign exchange losses have either remained uncovered or financed through expansion of the base money. In order to block this source of inflation, the recent stabilization program introduced the policy of financing these losses through the issuance of new public debt.

Under this new policy the Federal Government issues Treasury bills with a 5 percent interest rate and uses them to buy foreign exchange losses from the NBY. The NBY still forces commercial banks to deposit foreign exchange savings with the NBY and services that liability from the interest revenue earned on government bills and official reserves. The Federal Government uses taxes and seigniorage revenue to finance the interest payments on these treasury bills. These bills are the only "public" debt in Yugoslavia.

At the moment of creation (late December 1990), the accumulated amount of foreign exchange losses was estimated to be the dinar equivalent of $10 billion. In the meantime the foreign exchange savings of households has increased, and the dinar twice devaluated.

E. YUGOSLAV SAVINGS HELD ABROAD

The Yugoslav economy benefits because many citizens have been working abroad during the last two decades. Over 500,000 workers are still employed in Western Europe. They regularly send savings back to the home country and receive pensions from foreign countries after retiring in Yugoslavia. These workers' remittances are a large portion of the net inflow to the country's current account balance.

Capital inflow to and outflow from the saving accounts held with the Yugoslav banks are reported in Table 10. The net inflow of $1.25 billion in 1990 corresponds to the overall increase in net domestic savings of the household sector. Dinars saving deposits increased by $0.5 billion, while the remaining additional savings was in foreign exchange accounts held with domestic banks.[3]

Table 10 Net inflow of workers remittances (US$ billion)

	1989	1990
Workers remittances	8.01	11.83
Withdrawals from foreign exchange accounts held with domestic banks	6.18	10.58
Net inflow	1.83	1.25

Source: Savezi zavod za statistiku (1991)

Workers remittances primarily serve to finance private consumption. It is hard to estimate which part of the total withdrawn from foreign exchange accounts promotes direct imports of goods and services, and what remains for domestic consumption. In any case the ratio of foreign exchange withdrawn to total consumption outlays has constantly risen, and it explains the relatively stable level of aggregate consumption during the past years of industrial recession (see Table 11).

The total amount of workers remittances is high, increasing in the last two years to 13-18 percent of GDP. Since the average gross savings ratio in the OECD economies exceeds this figure by only a few percentage points, it could be concluded that workers' remittances are the main, readily available, source of investment capital that could be used to purchase socially-owned enterprises.

[3] Figures on savings reported by the Yugoslav statistical service are not considered here since they include foreign currency gains and substantially inflate the real changes.

Table 11 Share of foreign exchange withdrawals in consumption outlays

1984	1985	1986	1987	1988	1989	1990
6.6%	5.4%	4.4%	10.0%	11.9%	15.1%	25.6%

Source: Savezni zavod za statistiku (1991)

There are, however, two obstacles that impose limits on any massive use of workers's remittances for purchasing social enterprises:

- High risk due to political instability, and
- Deteriorating standard of living due to the general economic crises and the rising level of unemployment.

The total amount of workers remittances increased in 1990 by 47 percent compared to the previous year, while the withdrawals from savings accounts exceeded it and increased by 71 percent. Consequently, the net inflow of foreign exchange only moderately increased by $579 million. Political instability increased substantially in September last year, which was immediately followed by a huge capital outflow and the breakdown of the foreign exchange market. The internal convertibility of the dinar ceased three months later.

The point is that workers remittances have already reached a rather high level which is unlikely to be increased further. Workers employed in the social sector earned last year $4,300 on average, while the average value of workers remittances per worker employed in social enterprises amounts to $2,300. The question is what political, institutional, and economic measures should be adopted to stimulate reduction in consumption and promotion of additional savings out of workers remittances. Obviously, the program of ownership restructuring in Yugoslavia must answer this question.

F. REDUCED CONSUMPTION - INCREASED SAVINGS

One way to finance private purchases of social enterprises is to reduce current consumption and thus increase savings. This suggestion seems very appealing if one includes the savings of Yugoslav "guest workers" in Western Europe. However, some caution should be expressed since this source of investment capital crucially depends on strong and effective incentives. Otherwise, the general public would prefer consumption, foreign currency savings, and traveling abroad.

Table 12 Ratio of consumption to GDP in 1987 (%)

Country	%
Yugoslavia (non adjusted GDP)	50
Yugoslavia (adjusted GDP for excessive increase in inventory stocks)	63-65
Greece	66
Portugal	67
Spain	63
Hungary	70
Bulgaria	71

Source: OECD (1990)

Also the impact of the current recession and high unemployment should be taken into account. Workers remittances are a large part of household income (see Table 15), and strong incentives are needed to convert consumption into additional savings. The propensity to save depends on the expected earnings from alternative uses of income. If the privatization program offers shares with more attractive yields then other alternatives, owners of foreign exchange may swap them for share in enterprises.

To get a feeling about the size of aggregate consumption in Yugoslavia, the shares of consumption in GDP are reported in Table 12 for Yugoslavia and a few other countries[4]. After adjustment for the overvalued GDP in Yugoslavia, the share of aggregate consumption in Yugoslavia can be compared with those shares in Spain, Greece, and Portugal. However, these economies have different gross saving rates, and it is hard to estimate the potential increase in savings after a suitably motivated decrease in general consumption. Finally, it should be noticed that the share of consumption was increasing after 1987, and reached 67 percent in 1990.

G. EXISTING DOMESTIC CAPITAL

There are a small group of private banks and a large number of small-scale private enterprises operating currently in Yugoslavia, but it is unclear how much investment capital they possess and how much they are willing to invest in purchasing socially-owned firms. Most likely, they are more willing to set up new businesses then to take over existing social enterprises.

Another possibility is that the household sector holds financial claims in an amount equivalent to 12 to 15 percent of the socially-owned wealth. The main form of these financial assets are deposits held with commercial banks, denominated in dinars and foreign currency (see Table 13).

More then a half of the total households foreign exchange savings is held in liquid (short-term deposits) assets. They serve as the medium of exchange and are used for financing current consumption. The remaining part is not liquid, and it constitutes long-term savings.

Using the foreign exchange deposits to purchase social enterprises would certainly impose harsh liquidity constraints on commercial banks. As shown in Table 13, short-term households deposits (in foreign currency) are 35 percent of the total short-term bank deposits. This percentage increases to 75 percent if the long-term deposits are included.

Table 13 Household deposits at the end of 1990 (US$ billion)

Total foreign exchange deposits	12.1
- Long-term deposits	5.3
- Short-term deposits	6.8
Dinars deposits (equivalent to)	2.2
Short-term households deposits/Total banks short-term deposits	35%
Long-term households deposits/Total banks long-term deposits	75%

Source: Savezni zavod za statistiku (1991).

[4] Statistical definitions of GDP and consumption expenditures are not unified, since Yugoslavia, Hungary and Bulgaria adopted the Net Material Product accounting system, while the other quoted countries use the System of National Accounts as recommended by the United Nations. There are, also, errors in the Yugoslav methodology of compiling national accounts due to high rate of inflation, which excessively builds up the stock of inventories.

It makes more sense to think about debt-equity swaps instead of expecting direct purchases of social enterprises using the existing private capital. To strengthen that point, note how much of the liabilities of the social enterprises are held by the banking system.

Table 14 Loans to social enterprises from the banking system in 1990 (US$ billion)

Dinar denominated long-term loans	4.5
Dinar denominated short-term loans	11.3
Total loans from domestic banks	15.8

Source: Savezni zavod za društveno planiranje (1991).

Due to the present crisis on the foreign exchange market in Yugoslavia, all foreign currency deposits of households virtually become preferred shares that can not be traded on the market. This is, of course, a very bad state of affairs, but it also highlights the ambiguous treatment of foreign currency savings. They are financial assets held by households against financial liabilities of the Federal state or the NBY. Since, the Federal state and the NBY do not hold adequate official reserves, these deposits constitute government debt. The only difference is that this debt is a fully-index liability of the Federal Government.

A debt-equity swap could be carried on between households, commercial banks, and social enterprises. Households would exchange their bank deposits for equity in enterprises.

H. FUTURE SAVINGS

There is no official data on the level of domestic savings. In the absence of official data, Table 15 provides an estimate. The estimated share of savings in total disposable income is 11.4 percent while the share of households savings in estimated GDP is 8.2 percent.

Table 15 Estimate of domestic savings in 1990 (US$ billion)

Net wages and salaries in productive activities	21.60
Net wages and salaries in non-productive activities	5.08
Workers' remittances	11.80
Transfer payments	6.50
Interest received	1.85
TOTAL DISPOSABLE INCOME	46.83
Consumption	41.50
TOTAL SAVINGS	5.33
- Increase in foreign exchange deposits	1.70
- Increase in domestic savings accounts	0.50
- Other Savings	3.13

ANNEX D

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ANNEX D: OWNERSHIP CLAIMS ON SOCIAL CAPITAL

A. INTRODUCTION

Various groups of citizens may have a claim to own or receive more of the social capital than other groups. Efficiency, equity, and the contribution to its creation are among possible criteria for judging such claims. The second and the third of these are clearly related but in no way identical. Persons and institutions who made contributions to social capital have clearly been in vastly different positions to make them.

The individual contributions made by decision-making units are simply not identifiable. In a socialized system with utterly muddled economic relationships, the very process of accumulation and investment is socially driven and financed. The role of the separate economic entities in such an institutional set-up is relatively modest, so that any attempt to identify individual contributions has little basis.

In sum, there have undoubtedly been some variations in individual contributions, but they do not seem to have much relevance for privatization policy. Firstly, contributions primarily appear on the level of the collective, without any clear way of allocating it to the individual members. Secondly, there have been large changes in the employment and size of the collectives. Thus attributing the results of capacity expansion to various participating agents becomes impossible. Many of those who worked and took part in decision making processes are simply not alive.

B. ON SOURCES OF INVESTMENT FUNDS

Social capital growth was financed primarily through the following four channels:

- administratively imposed forced savings generated and allocated by the state, either through the budget or through special funds;

- substantial amounts of foreign aid which in the 1952-64 period amounted to about one third of net investment (more accurate estimates could perhaps result in an even higher value);

- bank credits; and

- internal savings.

In addition to this, there was an initial quantity of state capital obtained by nationalization, confiscation, sequestering, and other ways. As shown below, even nationalization amounted to outright expropriation because the institutions and funds necessary for administering compensation have simply never been put in place. In the course of time bank credits and internal savings became dominant.

It is quite easy to argue that none of the above mentioned sources of capital can be attributed to individual working collectives, not to speak about their individual members. That is self-evident as for as the first two sources are concerned.

As for bank credits, they also contain a large socialized component. Firstly, many credits were granted on concessionary terms. Because of difficulties and lack of discipline in servicing of these credits, a large part of them was rescheduled on favorable terms. Thus a large part of bank credits became a source of socially provided capital. Secondly, the bulk of these credits, were utilized and serviced under the conditions of high and accelerating inflation and negative interest rates. Such financing of investment caused spectacular redistributions not only of income but also of wealth.[1] This amounted to massive socialization of capital formation flows.

Internal savings originate from the so-called income of enterprises. Income is a heterogenous category containing contributions not only of labor but also of complementary production factors such as capital and natural resources. Contribution of entrepreneurship is also included, but this contribution can hardly be attributed to all employees. This contribution was made by a few talented and educated senior managers, but their undoubtedly large addition to "income" is impossible to measure. The basic argument, however, is that retained earnings are formed out of contributions of the complementary production factors and not out of the contribution of labor.

Contributions to social capital growth by workers did not typically involve great sacrifice. Moreover, merely having a job has rightly been considered to be a privilege. Attributing the accumulation of social capital to the employees would amount to piling privilege upon privilege. Also it is important to note that the level of retained earnings in an enterprise was positively correlated with the level of personal incomes. Those who "contributed" to the social capital the most were at the same time paid far above the average, often without having shown above average performance. Ascribing social capital to the working collectives - not to speak about their individual members - seems to be out of the question.

In view of the above, capital can only be treated as wealth which belongs to all citizens. Furthermore, it is impossible to establish a basis on which one could estimate individual shares in the eventual distribution of social capital.

Due to political differences in the country, social capital is about to be appropriated by the Republics. The ruling principle is evident: the Republican states will lay their hands on whatever is located on their territories. True, there have been establishments located on the territory of one Republic owned by the organizations belonging to other Republics. But property rights are generally poorly defined and even more inadequately enforced. The expropriations of properties of one Republic by another have been frequent in Yugoslavia. Allocative decisions and redistributive processes have been pooling and reshuffling resources all over Yugoslavia. Social capital has been formed as all-Yugoslav property. However, political developments have allocated socially-owned means of production to each Republic. The citizens of each Republic will be able to claim only capital located in their own Republic.

The position of various categories of citizens will depend on the strategy of privatization that is adopted. Both selling social property for fair market value and giving it away for free to all citizens could give equal treatment to all citizens. The farmers, the economically inactive and the unemployed have not derived any benefits from the socially-owned capital despite its having nominally been owned by the entire society. The just and politically acceptable way of doing away with social capital is to have all social groups and individuals derive from it equal benefit.

C. THE WAYS OF CREATING THE INITIAL FUND OF SOCIAL CAPITAL

1. NATIONALIZATION

The roots of nationalization reach very deeply into the socialist ideology on which the new society was to be based. Building socialism meant above all concentrating resources under the state's umbrella and orienting individuals towards the state by making them dependent on it for their livelihood. The two major sources of

[1] See Bajt (1985. p. 17-35) and Mates (1987. p. 419-431).

revolutionary zeal was the pride of the workers in becoming the masters of their own destiny and retaliation against the former collaborators with the occupying enemy forces.

There were three waves of nationalization. The first was inaugurated by a law passed in December 1946, the second in 1948, and the third one was in 1958.[2] Nationalization started with the commanding heights of the economy - Federal and Republican banking, insurance, industry, mining, transport, and wholesale trade establishments. In 1948 local industries and transport, retail trade, and catering were included.[3] The 1958 nationalization applied to building sites and housing, whereby the dwelling units in excess of three apartments were nationalized.

Nationalization was greatly facilitated by the fact that about one half of productive assets outside of agriculture had been owned by foreign nationals. Some of these assets belonged to the occupying countries or Yugoslav national minorities attached to them. These assets were simply confiscated without indemnity, which significantly eased the financial burden of creating the new state sector. At the same time, a part of that property previously owned by Jews had been confiscated by the Germans and their allies, and the owners succumbed tragically during the war. In this case the issue of compensation could not have arisen even theoretically. A number of people made gifts to the revolutionary government, thus easing again the burden of compensation. Part of them were convinced communist activists and participants in the revolution, while the others had an uneasy conscience on account of economic and even political collaboration with the enemies and were happy to strike deals with the government.

A sizable portion of productive potential had already been owned by the former Yugoslav government. These assets included railways and roads, vast expanses of forests, the entire defence industry, large coal and iron ore mines, a number of large agricultural estates, the biggest banks, and two sugar refineries. The bulk of exports and imports was also under governmental ownership and control. This capital went automatically to the newly created state sector.

2. AGRARIAN REFORM

Agrarian reform was only partly used as a means to expand the state sector. Its other purpose was to strengthen the poor peasants and to even out the distribution of the land holdings. The first move, in the form of a land reform law, was made by the provisional Federal assembly even before the constitution had been adopted (1945). Another land reform took place in 1953. Both reforms thus meant the change of property ownership in two distinct ways. Firstly they changed the proportion of the public relative to private land and, secondly, the size distribution of the land holdings. This was based on the class basis of the liberation war and of the resolute move to eliminate large capitalist estates.[4]

About half of the acquired land was distributed among the peasants, the other half directly transferred into state ownership. The total amount of land affected by the reform was about one fifth of the available area, but the effective quantity of redistributed land was much greater - most of it was the high quality land in fertile areas in the northern part of the country.

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[2] See Horvat (1976. p. 7).

[3] See Bićanić (1972. p. 26).

[4] See Bjelogrlić (1973. p. 16-17).

The first land reform operated on the principle that the maximum size of the holdings should be 35 hectares for the farmers and 5 hectares for the non-farmers. The second reform cut down the size of the maximum for farmers to 10 hectares, which was considered the largest amount that a farmer would be able to till without resorting to hiring (and thus "exploiting", as the official theory hat it) other workers. The second reform involved 276,000 hectares. All of it was distributed to agricultural estates and various types of cooperatives.[5] It thus gave another boost to the social sector in agriculture.

Agrarian reforms thus contributed to the public sector expansion, but at the same time postponed the decisive thrust to incorporate agriculture entirely into the collective economy. The new campaign of transforming the privately owned and operated agricultural sector into one based on a collective principle - and thus aligned with the rest of the economy - came with forceful creation of the peasant workers cooperatives (PWC), which were the Yugoslav variant of "kolkhozes". The justification for this was simple. Efficiency of operation was an increasing function of size, and thus peasants should be combined into large organizations.

The collectivization movement gained in momentum. By 1951 when it reached its peak, the number of the PWC members was two million with the total arable land area exceeding 2 million hectares. Then the movement began to recede. Already in the following year, membership dropped to 1.5 million and the available collectivized land to 1.7 million hectares. The corresponding figures in 1953 were only 193,000 and 329,000 respectively.[6]

This was the first instance of privatization in Yugoslavia. The public sector primarily involved the nonagricultural part of the economy. As for agriculture, state-owned or socially-owned land amounted to some 16 percent of arable land. True, this is the highest quality land at the best locations, so that the effective share of the public sector in agriculture is substantially higher.

D. LEGAL BASIS AND OBJECTIVE CONDITIONS OF NATIONALIZATION

Nationalization affected even important segments within the government sector. Municipal and provincial governments as well as local government bodies owned before the war sizeable chunks of property. It was completely transferred to the central government, including even local forests and village pastures. Thus one can speak of a total nationalization which not only made individuals dependent on the (central) state, but also undercut the economic basis of autonomy by the lower levels of social organizations. Thus the full concentration of power and an effective control of the society by the central government was assured.

As for foreigners who had been the citizens of allied or neutral countries, compensation was given with some delay. The government was faced with the dilemma of either denying this right and thus saving on financial outlays or being denied access to foreign trade and other channels of international cooperation. The government decided in favor of orderly compensation. Of course, the respect for international law and the desire to be considered a reliable member of the international community also played a role in opting for such a policy.

The legal basis for nationalization was provided by the first Yugoslav constitution adopted in January 1946. It firmly consolidated state ownership and give it a full fledged monopoly in the economic sphere of social life. That was in accordance with the monopoly of the revolutionary party in the political life.

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[5] See Horvat (1976).

[6] See Horvat (1976. p. 112).

Nationalization was implemented through some twenty-odd laws and executive decisions having in some aspects the force of law enacted between 1945 and 1965. Most of them, however, were promulgated immediately after the war.

The laws whose purpose was to operationalize the taking away of property, were launched with maximum speed, reflecting the revolutionary real of the time. In contrast, the laws needed to regulate compensation of the owners were not implemented so quickly. In fact, the vast majority of such laws have never been created, and compensation has not been provided for the bulk of nationalized property.

Thus, nationalization degenerated into out right confiscation. The large amount of property that was to be confiscated as a matter of explicit legal ruling was further enlarged by this roundabout confiscation. The exact figures are not known, but it is certain that the preponderant part of planned and legally prescribed compensations were never made. In particular, the acts identifying the institutions which would provide compensation and securing the necessary sources of funds have never been legislated.

Not only did the owners of factories and workshops go without compensation, but even the people whose flats and shops were taken away never compensated. Moreover, there were a large number of institutions which were empowered to take away property without formal process. However, the institutions charged with providing compensation were never created. Much property was taken as a punishment for the peasants failing to meet obligatory delivery targets. The entire process was loaded with injustice. It seems that a strong case could be made for restitution of property and rightful, if belated, compensation.

Yet, along with the state property, two other types of property were recognized. Cooperative property was a favored type of ownership and, in the wording of the constitution, was to be given special attention by the state. Also the remnants of private property were tolerated.

The constitution laid the foundations of a system which many years later, was aptly characterized by H. Lydall[7] as one which constrains rather than liberates economic activity. The system imposed many constraints even on the social sector, but, of course, the principal limitations were placed on the private sector. The constitution banned all forms of private monopolies, such as cartels, but failed to include monopolies in the state sector. Large private agricultural estates were strictly prohibited. There was also a catchall regulation according to which private property may not be used to the detriment of the socialist community which allowed for a wide range of interpretations.

E. CONCLUSIONS

Legitimate and theoretically justifiable claims on social capital do not exist. It is not possible to demonstrate that the contributions to social capital have been the result of any specific endeavor or individual sacrifice. Even though there are instances of collectives having created large establishments from scratch, the employees who have invested the most have, by and large, also enjoyed the highest personal incomes. The most deprived have been the jobless - the ones without a chance either to earn their living or to contribute to social-capital growth.

Business savings have been formed out of capital's contribution to income. The initial quantity of social capital has been secured in ways which in no way reflected the contribution of the employees. Subsequent social-capital growth was fueled through a multitude of fiscal and inflationary ways which certainly had affected all citizens, but no one in particular. It is also important that the risk of the investment decisions

[7] See Lydall (1984. p. 272-275).

has not been borne by the individuals managing social enterprises. Without exception, this risk has been socialized. In short, what has been created in a socialized way cannot be - except in an arbitrary way apportioned across individuals. In conclusion, there is no basis for establishing legitimate claims on social capital.

ANNEX E

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ANNEX E: CONCENTRATION OF ECONOMIC ACTIVITY IN LARGE FIRMS

In the following table, the term "firm" refers to a Basic Organization of Associated Labor (BOAL). In many cases, a BOAL is not an independent decision-making entity and is part of a larger "complex organization." Thus this table may overstate the number of independent enterprises in each industry. The data is for 1988 and is taken from the *Statistical Yearbook of Yugoslavia, 1990*. A "large firm" is defined to be one that employees more than 250 persons or with a value added greater than 40,000 average gross wages.

		Large Firms by Net Product			Large Firms by Employment		
	Total No. of firms	No. of firms	% of Total	% of Total Net Product	No. of Large Firms	% of Total	% of Total Employment
TOTAL SOCIAL SECTOR	24,963	797	3.2%	66.5%	423	1.7%	12.6%
INDUSTRY AND MINING	8,372	502	6.0%	76.6%	279	3.3%	16.0%
Power	467	16	3.4%	25.5%	8	1.7%	17.2%
Coal Mining	113	14	12.4%	46.6%	5	4.4%	19.9%
Coal Processing	8	3	37.5%	92.1%	4	50.0%	87.7%
Crude Oil & N.Gas	11	5	45.5%	89.4%	1	9.1%	40.1%
Refineries	29	8	27.6%	74.0%	6	20.7%	55.4%
Iron Ore Mining	11	3	27.0%	94.1%	5	45.5%	71.6%
Iron and Steel	118	21	17.8%	62.1%	6	5.1%	29.0%
Non-Ferrous Mining	57	6	10.5%	28.3%	10	17.5%	51.0%
Non-Ferrous Metals	38	13	34.2%	86.0%	7	18.4%	47.7%
Non-Ferr. Met. Process	48	11	22.9%	66.4%	4	8.3%	29.6%
Minerals Mining	79	3	3.8%	43.9%	7	8.9%	37.3%
Minerals Processing	152	8	5.3%	21.6%	10	6.6%	30.3%
Metal Processing	882	21	2.4%	12.9%	6	0.7%	5.2%
Machine Tools	498	38	7.6%	36.0%	4	0.8%	5.8%
Transport Equipment	282	32	11.3%	45.4%	16	5.7%	26.9%
Shipbuilding	67	10	14.9%	47.6%	5	7.5%	26.1%
Electrical Machines	505	50	9.9%	40.2%	7	1.4%	10.2%
Basic Chemicals	233	19	8.2%	33.1%	9	3.9%	21.0%

		Large Firms by Net Product			Large Firms by Employment		
	Total No. of firms	No. of firms	% of Total	% of Total Net Product	No. of Large Firms	% of Total	% of Total Employment
Chemicals	396	24	6.1%	33.9%	6	1.5%	0.0%
Stone and Sand	114	9	7.9%	26.3%	5	4.4%	16.8%
Construction Materials	322	3	0.9%	22.8%	3	0.9%	6.3%
Lumber	219	10	4.6%	14.4%	3	1.4%	7.7%
Final Wood Products	519	8	1.5%	8.3%	18	3.5%	16.8%
Paper and Pulp	150	21	14.0%	34.9%	9	6.0%	27.7%
Textiles	252	25	9.9%	23.2%	8	3.2%	12.7%
Garments	738	27	3.7%	14.6%	9	1.2%	8.0%
Leather	58	3	5.2%	21.9%	10	17.2%	41.5%
Shoes	242	10	4.1%	18.3%	8	3.3%	18.3%
Rubber	86	7	8.1%	41.8%	8	9.3%	34.9%
Food	863	52	6.0%	28.3%	28	3.2%	18.3%
Beverages	179	9	5.0%	21.6%	5	2.8%	15.6%
Animal Feedstuff	67	3	4.5%	25.0%	4	6.0%	19.4%
Tobacco	94	7	7.4%	37.3%	9	9.6%	14.2%
Printing	305	2	0.7%	18.3%	17	5.6%	22.5%
Recycling of Inputs	118	1	0.8%	15.2%	3	2.5%	12.6%
Other Industry	52	3	5.8%	59.4%	6	11.5%	47.7%
AGRICULTURE AND FISHING	3,329	16	0.5%	6.8%	17	0.5%	6.4%
Agriculture	2,281	8	0.4%	7.6%	11	0.5%	6.2%
Agriculture Services	5,982	3	0.3%	7.3%	2	0.2%	2.6%
Fishing	66	5	7.6%	41.7%	4	6.1%	28.4%
FORESTRY	444	11	2.5%	20.0%	3	0.7%	6.0%

		Large Firms by Net Product			Large Firms by Employment		
	Total No. of firms	No. of firms	% of Total	% of Total Net Product	No. of Large Firms	% of Total	% of Total Employ-ment
WATER SUPPLY	143	8	5.6%	26.9%	4	2.8%	11.8%
CONSTRUCTION	2,661	40	1.5%	21.3%	33	1.2%	13.7%
Buildings	882	16	1.8%	19.6%	24	2.7%	19.0%
Civil works	478	15	3.1%	37.4%	8	1.7%	13.3%
Construction Services	1,301	9	0.7%	11.4%	1	0.1%	1.7%
TRANSPORTATION	1,575	53	3.4%	24.7%	57	3.6%	20.8%
Railway	207	4	1.9%	11.2%	9	4.3%	19.3%
Sea Transport	36	13	36.1%	89.1%	9	25.0%	70.7%
River Transport	14	5	35.7%	77.9%	2	14.3%	59.5%
Air Transport	34	5	14.7%	65.5%	3	8.8%	43.9%
Road Transport	736	3	0.4%	8.7%	8	1.1%	8.7%
Urban Transport	151	7	4.6%	23.2%	10	6.6%	27.7%
Pipelines	11	5	45.5%	91.1%	4	36.4%	76.1%
Reloading Services	88	8	9.1%	40.1%	5	5.7%	34.7%
Postal Services	298	3	1.0%	6.1%	7	2.3%	13.5%
TRADE	3,263	131	4.0%	15.4%	15	0.5%	4.2%
Retail Trade	1,821	76	4.2%	14.2%	7	0.4%	3.9%
Wholesale Trade	1,153	28	2.4%	13.7%	6	0.5%	4.4%
Foreign Trade	289	27	9.3%	23.7%	2	0.7%	5.5%
TOURISM AND CATER-ING	1,245	14	1.1%	13.4%	5	0.4%	3.8%
Tourism	1,179	9	0.8%	7.0%	2	0.2%	2.1%
Tourist Agencies	66	5	7.6%	51.4%	3	4.5%	31.3%
PRODUCTIVE CRAFTS	1,036	6	0.6%	6.3%	1	0.1%	1.7%
PRODUCTIVE UTILITIES	709	3	0.4%	8.4%	5	0.7%	7.8%

ANNEX E

		Large Firms by Net Product			Large Firms by Employment		
	Total No. of firms	No. of firms	% of Total	% of Total Net Product	No. of Large Firms	% of Total	% of Total Employment
OTHER SECTOR	2,186	13	0.6%	9.8%	4	0.2%	3.4%

ANNEX F

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ANNEX F: PRIVATIZATION IN WESTERN ECONOMIES

A. INTRODUCTION

The privatization experience in Western economies, specially in Western Europe, is not directly relevant in preparing privatization programs for Eastern European countries including Yugoslavia. The task of privatization in Eastern Europe is completely different from in the West.

In Western economies, privatization merely meant the change of ownership. State-owned enterprises (SOEs) were transferred to private owners (individuals and institutions). But both before and after privatization most SOEs were managed, from a technical point of view, in much the same way, i.e. in a corporate manner as were all other corporations. The basic change was that prior to privatization the government appointed the boards of directors and after it the new private owners appointed the boards.

In line with that, the main objective of privatization was to improve the efficiency of former state-owned enterprises. Experience indicates that the private sector is more efficient in managing enterprises than the government. This is mostly due to the fact that governments are very likely to impose on their enterprises the need to fulfil a rather broad set of economic and social goals. The private sector is much more inclined to insist on profit maximization as the primary or only goal in enterprise management. As a consequence of this, as well as some other factors, economic efficiency of private enterprises tends to be higher than in their public counterparts. On this basis privatization in Western economies was primarily justified.

Privatization in Yugoslavia, as well as in other Eastern European countries, is likely to mean something entirely different. Considering the case of Yugoslavia, the process of privatization should be an instrument for achieving three general goals.

First, full-fledged or "real" owners of socially-owned capital must be found. By this we mean the owners that have strong and natural incentives or interests to protect and increase the value of their property. At present social capital is treated as a public good, i.e. it belongs to everybody and nobody. In fact, no one has a strong interest to protect socially-owned capital. At the same time, everybody has a right to put a claim on income resulting from the productive use of social capital.

Second, privatization is also a necessary prerequisite for almost a complete overhaul of the economy. Due to improperly defined property rights, as well as other shortcomings of the existing economic system, the economy of Yugoslavia has become extremely inefficient in utilizing capital, labor, and other productive resources. Up to now all economic reforms in the country, as well as in the rest of Eastern Europe, have failed primarily because the redefinition of property rights was not a part of the reform package. If this reform is to succeed and the inefficiency of the economy is to be removed, complete redefinition of property rights is essential.

Third, privatization must be viewed as a cornerstone of the process of transforming the Yugoslav economy into a market economy. But transforming a non-market into a market economy does not mean only the introduction of properly defined property rights. It also includes the creation of a number of basic market-economy institutions. These include a financial market system, corporate governance of managers, equity ownership, a stock exchange, and a number of financial intermediaries (investment trusts, mutual funds, pension funds, etc.).[1]

[1] See Lipton and Sachs (1990).

Yugoslavia at present lacks all those institutions and financial intermediaries. Thus they have to be created if Yugoslavia is to be organized as a market economy. In other words privatization does not involve only the change of ownership in existing socially-owned enterprises, but the fundamental transformation of the economy.

In Western economies, privatization meant only the sale of state-owned enterprises to the private sector and did not involve a major transformation or restructuring of their economic institutions. Prior to privatization, state-owned enterprises in Western economies had a clearly defined owner (the state), with well established corporate governance. At the same time, these countries had well developed financial intermediaries, so that privatization was not connected with the need for institutional reorganization. It explains why Western experience is not directly relevant for the privatization in Yugoslavia, but still some lessons can be learned from it.

B. SCOPE AND METHODS OF PRIVATIZATION IN WESTERN ECONOMIES

Statistical data is limited on privatization of state-owned enterprises in the world. The best source is a recent World Bank study.[2] It contains data on the number of privatized companies in the 1980-1987 period. (see Table 17).

This study states that 407 state-owned enterprises have been privatized during the 1980-1987 period in all the countries of the world. Among European countries, the largest number of SOEs were privatized in the United King-

Table 17 Privatization of state-owned enterprises in various countries.

		NO. OF FIRMS
North and South America		126
Africa		83
Asia and Pacific		53
Europe		
United Kingdom	48	
Italy	33	
Spain	30	
France	25	
Other	9	
Subtotal		145
TOTAL		407

Source: Vuylsteke (1988) 0

[2] See Vuylsteke (1988).

dom.[3] When this is contrasted with the fact that thousands of enterprises should be privatized in Yugoslavia, the gigantic dimension of this undertaking become quite apparent.

It is widely recognized that the privatization carried out in the United Kingdom was the most successful. The Government of Mrs Thatcher has managed to privatize something less than five enterprises per year an average. This also shows that privatization in Western economies had a restricted scope and significance compared to Eastern Europe. In certain countries, privatization included several to several dozen SOEs, and was usually carried out over the period of several years. In addition, in all these countries the private sector was large even before privatization, typically larger than the public sector. In Western European economies prior to privatization, the public sector in none of them produced more than 17 per cent of the total output or employed more than 20 per cent of the work force.[4]

In Western economies, the object of privatization was the transformation of ownership of a rather small amount of capital relative to the national wealth of those countries and total business capital. Needless to say the situation in Yugoslavia is fundamentally different in this respect, and the issue of privatization should be dealt with in quite a different way. For, if privatization in Yugoslavia is to be carried out following the example of the United Kingdom, it would take almost 1,000 years to complete. In our case, privatization has considerably greater significance, since it should encompass almost the entire economy. In other words, privatization in Yugoslavia represents the beginning of a fundamental reorganization of the country's economic life.

The methods and techniques of privatization practiced in Western economies are also not very relevant to Yugoslavia. The previously quoted World Bank study distinguishes seven methods of privatization.[5] But these can be reduced to three basic methods:

- public offering of shares. The state sells to the general public all or part of the stock it holds in an SOE;
- private sale of shares. The state sells all or part of its share holding to a single purchaser; and
- worker-management buyout. The state sells its shares to the employees and management of the SOE.

World wide the largest number of enterprises was privatized through a private sale of shares (258 or 63.4 percent), while 123 enterprises (30.2 percent) were privatized through a public offering of shares. Only 26 SOEs have been privatized through worker-management buyouts (6.4 percent). Worker-management buyouts primarily occurred in the United Kingdom and was of marginal importance in other Western economies. This is in line with the theoretical conclusion and empirical evidence which suggests that outside investors tend not to invest in enterprises in which workers have a controlling interest.[6] Because enterprises

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[3] See Dehesa (1990). This study claims that more than 200 companies were privatized in this country between 1984 and 1990. This number, however, includes partly privatized SOEs. In the World Bank study, partial privatizations have not been taken into account.

[4] See Lipton and Sachs (1990).

[5] See Vuylsteke (1988).

[6] See Lipton and Sachs (1990).

are controlled by workers and managers, they are prone to absorb all of the income in the form of wages. They are even more likely to behave in this way if internal share ownership is widely spread, i.e. if each owner actually owns only a small number of shares.

This conclusion should be given serious consideration in development of the privatization program in Yugoslavia. Namely, there is a preference in our country for privatization through the issue of internal shares to workers and managers of socially-owned enterprises. This method of privatization is similar to a worker-management buyout. In other words, Yugoslavia tends to apply a type of leveraged worker--management buyout approach to privatization.

Since reconstruction and technical modernization of our economy requires foreign capital, particularly in the form of direct private investments, such insistence on privatization through the issue of internal shares should be seriously reconsidered. This means that ownership control to a large extent is going to be given to inside investors, which can make our enterprises unattractive for private capital from abroad and from domestic sources as well. In addition, if ownership control over Yugoslav enterprises is to be in the hands of employees (workers and managers), it is difficult to see how corporate governance of newly privatized firms will be improved.

C. GOALS AND OBJECTIVES OF PRIVATIZATION IN WESTERN ECONOMIES

On the basis of the World Bank statistics, up to now 38 countries have engaged in privatization of their SOEs. Therefore, it comes as no surprise that the objectives of these privatization program vary widely among the countries.[7] According to World Bank analysis, privatization programs had one or more of the following objectives:

- budgetary relief from the financial burden of SOEs (subsidies, debt service requirement),
- relief from the administrative burden (management, control),
- increased efficiency of enterprises,
- greater revenue from state assets,
- improved business conditions (fostering development of private sector),
- increased competition in the market,
- development of wider business ownership, and
- development policies rationale (withdrawal of the government from certain economic activities).

Even for a particular country, objectives of privatization tend to be rather numerous. It is also frequently pointed out that many governments have never defined a comprehensive list of objectives for their privatization programs. Since privatization in the United Kingdom has drawn so much attention both

[7] See Vuylsteke (1988).

worldwide and in our country, it would be interesting to quote a list of privatization objectives in that country.[8] These are:

- improving efficiency by increasing competition and allowing firms to borrow from the capital market,
- reducing the public sector borrowing requirements,
- easing problems of public sector pay and salary determination,
- reducing government involvement in enterprise decision making,
- widening the ownership of economic assets,
- encouraging employee ownership of shares in their companies, and
- redistributing income and wealth.

The differences in these two lists mainly reflect the fact that the former largely refers to privatization objectives in less developed countries and the latter to the United Kingdom (a developed country). All of the countries, however, are capitalist market economies. Still greater differences can be seen when comparing individual countries. This is even true when countries are rather similar, as is the case of the United Kingdom and Spain (both of them being members of the EC).[9] This only illustrates the fact that each country has undertaken privatization for specific reasons, which are reflected on their objectives.

If we compare the objectives of privatization in Western economies with those in Yugoslavia (and other Eastern European countries), we find substantial differences. This is due to the fact that Yugoslavia is only partially a market economy, so that here the most general objective of privatization is a fundamental transformation of the economy. That is to say, transforming a non-market into a market economy, including the creation of all the basic institutions of a financial market. In contrast, privatization in Western countries did not involve any significant transformation of the structure and institutions of their economies. As a result, privatization in the West did not include those objectives that are going to be of prime importance in the case of Yugoslavia (defining the real owner of social capital, introducing corporate governance, equity ownership, stock exchange, creating financial intermediaries, etc).

Improving the efficiency of enterprises seems to be the only high priority privatization objective in both Yugoslavia and Western economies. However, the way it should be achieved is essentially different. In Yugoslavia it should be done primarily through transferring ownership to an individual or institution and introducing corporate governance in enterprises. In the West the same objective was to be achieved by the sale of public corporations to the private sector and by improving competition in the market. These differences in the objectives of privatization reflect very different economic conditions under which privatization is undertaken.

In Western economies, some socio-economic objectives also played quite a significant role (widening the ownership of economic assets, encouraging employee ownership, redistributing income and wealth). It seems that these objectives frequently had crucial influence on a number of key policy decisions in designing and

[8] See Yarrow (1986) and Vickers and Yarrow (1988).

[9] See Yarrow (1986) and Dehesa (1990).

implementing privatization programs.[10] In Yugoslavia, they have to be observed from quite a different perspective, when and if they become the objectives of privatization. We already have a very wide spread ownership of economic assets, since a large part of total economic assets is socially-owned (in other words by all members of the society). That is why in Yugoslavia a primary goal of privatization should be social equity in redistributing social capital among the members of society. If social equity is not a prominent objective, the new capitalist system may be discredited from the beginning.

In Western economies, privatization to a large extent was motivated by a desire to relieve the government from the financial and managerial burden resulting from a large public sector. In fact, the justification of having a large public sector which needs to be heavily subsidized was questioned in almost all the Western countries. This was particularly true in cases when similar enterprises operate in the private sector, in the same or other countries, and perform efficiently. Consequently, this public sector became an unnecessary burden not only for the government but for the society as a whole. Thus privatization in these Western economies was oriented toward transformation of inefficient public enterprises into efficient private ones.

Of course, one may wonder whether it would be better for the government to have undertaken restructuring of public enterprises and thus made them more efficient instead of having them privatized.[11] This question raises important theoretical issues. For, even if the government could make public enterprises as efficient as private ones, there is still the issue of a need for the government to manage and control such enterprises, especially if they can be managed with equal efficiency by private managers and owners, at no cost to the government.

Until recently, state-owned enterprises in contrast to socially-owned enterprises did not exist in Yugoslavia, which also explains why the objectives of privatization are different for Yugoslavia. Indeed, in Western economies the principal aim of privatization was to increase the efficiency of and reduce the burden (financial and administrative) on the government in running those enterprises. Accordingly, they not only had to accommodate privatization objectives, but also the methods and techniques of privatization to fulfil this aim. This also explains why Western experience in privatization is not of much relevance to Yugoslavia.

D. COMPREHENSIVENESS OF PRIVATIZATION

Privatization in Western countries was typically carried out through the sale of public enterprises to the private sector. In most of the countries, privatizations carried out over the past decade involved not more than a dozen enterprises. Only in a few countries were more than 30 public enterprises privatized. Therefore, privatization included only a small segment of the economy and was undertaken sporadically and slowly.

The only exception, at least as far as Western Europe is concerned, seems to be the United Kingdom. Privatization there was carried out as a long-term program, and it was not restricted only to industrial public sector enterprises. For almost 12 years after 1979, privatization i.e. transfer of economic assets and production to the private sector, played a major role in the economic policy of the United Kingdom. The privatization program was a long-term program carried out by stages and on three separate tracks.[12] The first track was the sale of public sector housing. In fact, this was the start of the privatization process in the United Kingdom in 1979. The privatization policy was worked out by the central government but imple-

[10] See Yarrow (1986).

[11] See Yarrow (1986).

[12] See Yarrow (1986).

mented at the local level. Privatization in the housing sector was carried out at an accelerated pace, so that in the 1979-83 period almost 600,000 housing units were sold (more than in the entire 1945-1979 period). The receipts from the sale of public housing have also increased rapidly (from £300 million in 1979 to nearly £2,000 million in 1982), so that this form of privatization can be assessed as very successful. Privatization of public housing continued after 1983, but at a somewhat slower pace.

The second track of the privatization program in the United Kingdom was the contracting out to private firms of publicly financed service activities (cleaning services, refuse collection, catering, parking facilities, housing repair, etc.). Preparation and implementation of this part of the privatization program was much more complex than the sale of public sector housing and required more time. Actually, the entire system of contractual arrangements, enforcement, and renewal had to be worked out so as to ensure efficient functioning of these economic activities within the private sector. That is why this process started later and was in full swing only in 1984. This program was also implemented by local government authorities.

The third track of the privatization program was the sale of public enterprises. Until 1984 it was the least important component of the privatization program. This was the most complex part of the privatization program in the United Kingdom and was largely the responsibility of the central government. This program mainly referred to complete or partial sale of public sector industrial corporations to private owners. Its implementation required special preparations for each enterprise.

Only by the end of 1984 did this part of the privatization in the UK become important. In that year, the sale of the first large public enterprise occurred (the sale of slightly over 50 percent of British Telecom). By the end of 1990, some 40 public enterprises have been successfully privatized. This was the core of the entire privatization program. Until 1984, privatization was limited to enterprises in those activities that already had been facing significant competition from private sector producers.

Although this privatization program reflects conditions in the UK, it offers an illuminating experience for preparing a privatization program in Yugoslavia. Namely, it can not be realistically expected that privatization of all socially-owned enterprises can be carried out in a uniform way. Therefore in the case of Yugoslavia, different approaches, methods, and techniques of privatization, may be required for the various sectors of economic activity in which social capital is engaged.

The second lesson to be learned from the UK experience is that the privatization program in Yugoslavia should be prepared, implemented, and controlled by the government authorities. That was the case in all Western countries where privatization encompassed more than a handful of enterprises. Since the privatization effort in Yugoslavia is much more complex compared with these countries, it is hard to believe that it could be implemented in the way now anticipated by the Federal Law, namely, that the state should pass laws stipulating the allowed methods and techniques of privatization, and that each SOE would make its own decision on whether and how to be privatized. Such a passive approach of the government could result in serious adverse economic and social implications.

E. THE PATTERN OF SHARE OWNERSHIP

In Western economies, a privatization objective was to promote widespread share ownership, by giving preferential treatment to small investors. At the same time in some of those countries (the UK being one example), employee share ownership was also encouraged (worker-management buyouts). Therefore, this experience should be examined because internal employee and widespread share ownership are being promoted as crucial instruments in privatizing social capital in Yugoslavia.

The most relevant experience is that of the United Kingdom, both because of the scope of the privatization effort and the clear objective of encouraging widespread and employee share ownership. The UK privatization, however, was relatively unsuccessful in achieving this objective.[13] Although the program was designed in a way which favored small investors, the evidence indicates that most of those subscribing to the share issues quickly sold their holdings. That is to say, individual small investors have tried to use the flotations as an opportunity to make a quick gain, rather than a chance to acquire a long-term capital investment.[14] Within one month of flotation the number of shareholders had sharply fallen. It was ultimately reduced to the level ranging between 1/2 and 1/6 of the original number for a number of privatized public enterprises.[15] In addition, some public companies in the UK were sold to private companies directly, and thus had no direct effect on spreading ownership.

In respect to employee share ownership, the UK privatization was also relatively unsuccessful.[16] Though the privatization program offered a variety of concessions to employees, the amount of shares acquired by the workers was very small. It usually did not exceed 5 percent of the original share issue. Thus in spite of encouragement of employee share ownership, workers did not show much interest in becoming shareholders in their companies.

An exception are a few public enterprises which were privatized through worker-management buyouts. The number of workers who become shareholders in such cases is certainly considerable. However, the number of such enterprises in the UK is very small.

Employee share holding is more widespread in the US, where it is usually known as an Employee Stock--Ownership Plan (ESOP). Even in the US, ESOPs have a very limited importance for enterprise management. Indeed, if one observes only firms with more than 1,500 employees, ESOP ownership exceeding 50 percent only occurs in firms employing about 0.4 percent of the total manufacturing labor force.[17] The number of firms in which ESOP ownership is between 20 percent and 50 percent is larger, but their employment is still bellow 2 percent of the total manufacturing labor force.[18]

Therefore, the practice of having employees control the enterprises, as the owners of a majority of shares, is not unknown in Western economies, but it is typically limited to a very small number of enterprises and almost a negligible proportion of the total labor force. Worker-management control of enterprises is therefore an exception rather than the normal way in which modern Western corporations are managed. This finding should be considered in developing a privatization program in Yugoslavia so as not to have exaggerated expectations that corporate governance of enterprises can be organized on the basis of internal employee share holding.

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[13] See Yarrow (1986).

[14] See Yarrow (1986).

[15] See Yarrow (1986) and Vickers and Yarrow (1988).

[16] See Yarrow (1986) and Vickers and Yarrow (1988).

[17] See Lipton and Sachs (1990).

[18] See Lipton and Sachs (1990).

In this respect, the French privatization program gave considerable attention to future management of state-owned enterprises after privatization. In fact, there was concern in France that privatizing such enterprises would not result in a single owner or a coherent group of owners with a sufficiently large proportion of shares so that efficient management and control of enterprises would be possible. This concern was based on the belief that the capital market in France is too thin in comparison to the United Kingdom to rely primarily on public placement as a dominant privatization method. France also lacked investment banks, which have managed public placements in the United Kingdom.[19]

In order to overcome these problems and ensure stable management of newly privatized enterprises, the French government concentrated on developing a "stable core" of owners.[20] The government invited single investors or groups of investors working together to buy at least 20 percent of an enterprise. The government also required bidders to hold the shares of the enterprise for at least five years. After receiving the bids, the government would select a winner to serve as the stable core. The winner was selected not only on the basis of the price offered, but also on the basis of its financial strength, reputation and experience, the quality of its management proposal, etc.[21]

In this way, the French government has tried to avoid excessive widening of share ownership to the extent that it might detract from the management of enterprises. In fact, the intention was to find at least one owner with a significant enough stake in each newly privatized enterprise, so as to guarantee good management in the long run. That is why the stable core owner was obliged to buy at least 20 percent of an enterprise and not to sell its share for at least 5 years.

This concern of the French government about successful management of enterprises was based on the fact that the capital market in France is not well developed. In other countries with more developed capital markets, this was not seen as a problem because a stable core owner could obtain control by buying shares on the stock market if the company was not well managed under widespread share ownership. In France it was not certain that there would be such a quick concentration of shares in the hands of a core owner with a strong interest in the efficient management of the enterprise.

This French experience is important for Yugoslavia. All the reasons that led the French government to apply the stable core approach to privatizing public enterprises are present but much more pronounced in Yugoslavia. Accordingly, danger from mismanagement of newly privatized enterprises in Yugoslavia is much greater if its privatization is to be based almost solely on internal share issues or widespread share ownership.

F. TECHNIQUES AND COST OF PRIVATIZATION

Specific techniques of privatization, used in Western countries have not been discussed, mainly because they are largely irrelevant for privatization in Yugoslavia. This is because the capital market is not developed in this country, financial intermediaries are almost nonexistent, there is neither a stock exchange nor experience with its functioning, etc.

We also have not discussed costs of privatization, although this issue is important. Based on the experience of the United Kingdom, privatization involves substantial transaction costs (around 3 percent of gross

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[19] See Lipton and Sachs (1990) and Andreff (1991).

[20] See Lipton and Sachs (1990) and Andreff (1991).

[21] See Lipton and Sachs (1990) and Andreff (1991).

proceeds from the sale of assets). According to business finance theory, share issue is often viewed as the costliest way to raise new capital[22].

G. COMPETITION AND MONOPOLY

For somewhat different reasons, we have not elaborated on the issue of competitiveness of the market and the monopoly position of manufacturers in the context of privatization. Yugoslavia has recently introduced import price liberalization and passed laws and regulations which have simplified the establishment of new enterprises. This has considerably weakened monopolies and increased the competitiveness of the market.

In implementing their privatization programs Western economies have also faced problems of competitiveness of the market and monopoly situations. This raises two issues

The first is how to regulate a privately owned firm with a so-called "natural" monopoly position in its market (telecommunication, gas, electricity). Creation of public enterprises was one way of solving the problem. If those firms are to be now privatized, a special regulatory mechanism inevitably needs to be established. The recognition of this problem in the case of telecommunications has led the UK government to create a special regulatory institution called OFFTEL, with power to constrain monopolistic behavior by the dominant firm.[23] In some other cases, a similar solution was adopted. The first evidence concerning the performance of privatized enterprises show that there was no efficiency improvements in sectors with significant natural, technological, and other monopolistic situations[24].

The second issue has to do with privatization of very large enterprises, created by vertical or horizontal integration. To enhance competition, it may be necessary to split such enterprises into smaller enterprises and then privatized.[25] In our country the host of existing large companies was created through merger under pressure from local government authorities and the Communist Party.

H. CONCLUSION

Privatization is an exceptionally complex undertaking, even for countries organized as market economies. Consequently, this problem in Yugoslavia is even more complex. That is why privatization should never be viewed in a simplified manner as only a transfer of ownership rights from society to individual citizens or workers. Privatization will be economically justified only if it will result in the more efficient management and operation of enterprises. Western privatization offers strong arguments in this respect, particularly in Western European countries. This is the crucial lesson to be learned from privatization in Western economies.

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[22] See Yarrow (1986).

[23] See Yarrow (1986).

[24] See Yarrow (1986) and Vickers and Yarrow (1988).

[25] See Hinds (1990) and Blanchard (1990).

ANNEX G

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ANNEX G: THE FEDERAL LAW ON SOCIAL CAPITAL

A. BACKGROUND

The Federal Law on Social Capital can be seen as an outgrowth of reformist thinking in the previous period in which the self-management system was sacrosanct. Until about 1988, the major preoccupation of the reformers was making self-management firms more efficient rather than privatization.

The first indication that this type of thinking was undergoing change came with the Enterprise Law that was enacted in December, 1989. According to this legislation, those who provide capital when founding a firm are given control instead of the employees. This applied to the "socially-owned" enterprises, the private sector already had such rights. Basically, the legislation had to do with the founding of new enterprises by "socially-owned" firms. Furthermore, socially-owned" enterprises were allowed to become "mixed companies" by attracting private equity capital. In these companies, control is divided between those who work with social capital and the owners of private capital.

The Law on of Social Capital enacted at the same time gave the power to the workers councils to sell companies to a private owner. The Law also specified that revenues from sales in each Republic have to be paid into a special investment fund called the Development Fund. Agencies were set up in each of the Republics to assist enterprises in this respect. This Law was amended in August 1990 in several important ways, the most important being that it allowed employee buy-outs through the purchase of "internal shares". The balance of this section analyzes this key law.

The Law expires in August 1991, by which time it will probably be amended and might be in contradiction with new or proposed legislation in the Republics concerning privatization. The status of the Federation including legislation on privatization is still undecided at this point and is a part of broader political issues that remain to be resolved. Nevertheless, it seems that the Federal Government will probably try to propose further amendments to the Law or new legislation on privatization with the hope that this legislation will provide the basis for a fast process of privatization, thus enabling the companies to pursue this road in order to by-pass more restrictive privatization laws in the Republics.

B. PROVISIONS OF THE LAW

The Law on Social Capital allows enterprises to procure additional capital by issuing shares or selling an interest in the enterprise. It defines social capital as the operating capital fund minus a proportional part of non-covered losses, as well as a proportional part of reserves and non-operating funds.

The Law allows enterprises to sell internal shares at a discount and prohibits the resale of these in the securities market. The possible buyers of internal shares are: a) workers employed in the enterprise, b) former employees of the enterprise and retired employees who have worked for the enterprise for at least two years, c) other domestic natural persons, and d) social security and pension funds. The decision to issue internal shares resides with the managing body of the enterprise i.e. the workers council. Consequently, it also decides whether the enterprise will become a mixed-ownership joint-stock company or a limited liability company. The number of "internal" shares that a company may issue is limited by the Law. Half of the total sum of shares can be sold to the workers while the other half can be sold to other potential investors prescribed by the Law i.e. other domestic natural persons and pension funds. The amount of shares sold to other than workers will depend on the availability of social capital to provide discounts.

The enterprise may issue internal shares up to the limit of six annual net wage bills. To avoid the problems associated with hyperinflation during the previous years, the Law provides for calculating this sum as a multiple of the six-monthly net wage bill. In other words, the first six months of 1990 when wages were fixed and inflation was down are to be used as a basis for determining the value of internal shares.

In addition, internal shares sold to the employees are sold at a discount of 30 percent of the nominal value of internal shares. Furthermore, each employee can obtain a one percent discount on top of the 30 percent for each year of employment in the enterprise. The maximum discount is fixed at 70 percent of the nominal value of internal shares and the value of such discounted shares is further restricted to three annual net wage bills of the enterprise. Retired employees can obtain internal shares under these same conditions.

The Law specifies that other domestic natural persons and pension funds can obtain internal shares at a discount not exceeding 30 percent of their nominal value. The value of these shares is also restricted to three times the sum of the annual net wage bill of the enterprise. Pension funds have the right to buy up to half of such internal shares.

In cases in which the value of social capital is greater than three annual net wage bills, the enterprise is obliged to issue internal shares to all other potential buyers referred to earlier (former employees, retired employees, domestic natural persons, and pension funds). In the opposite case in which the value of social capital is less than this sum, only employees have the right to purchase internal shares. If 100 percent of the shares are not sold to the employees, they can be offered again to all potential buyers specified by the Law. This means that if an individual employee has used his right to buy shares to the limit, he can purchase an extra number of internal shares at a maximum discount rate of 30 percent.

Obviously, the enterprise that decides to offer internal shares has to model and simulate its offer so as not to allow for the sum of discounts to exceed the value of social capital. If a simulated calculation shows this to be the case, the volume of shares will have to be less than intended by the Law. The value of social capital in the enterprise is decreased proportionally to the value of the discount granted on internal shares.

Individuals can purchase internal shares up to three net annual salaries. When it comes to former employees or retired employees, the enterprise is guided by salaries paid for such jobs within the enterprise or their skills. If all the shares that were offered are not bought, all restrictions concerning the volume of shares are suspended.

The rights of control are allocated to the owner of the shares according to their nominal value, while rights concerning dividends are restricted to the part of the shares that have actually been paid for. This provision is related to the provision in the Law that allows for paying for shares in installments with the maximum period being ten years. The enterprise is obliged to evaluate the worth of shares each year. The purchaser of shares loses his discount and that part of internal shares that he did not pay for if he doesn't meet his installments in the specified term. Naturally, the term is flexible under the limit of ten years, and shares can be bought in full for cash immediately.

Concerning the valuation of the firm, the Law allows for book value as a basis for selling internal shares. It also allows for independent valuations to be done under the auspices of the privatization Agency.

The Law also allows for companies to be sold to other domestic and foreign legal or natural persons. The proceeds from such a sale belong to the firm either in whole or in part. If a part of the company is sold and registered as a new legal entity, the proceeds from such a sale belong in full to the firm that sold its part. Sales are done through auctions and can not be implemented without consent from the Agency. The decision to sell a firm or its parts rests with the management of the firm, in other words, workers councils in socially-owned enterprises.

The proceeds from the sale of firms or their parts belong to the Development Fund (hereafter the Fund), an agency established within each Republic. It should be stressed that the Fund can reinvest in the firm. This reinvestment in a specific company is limited to five percent of the total assets of the Fund. However, it can reinvest all the proceeds from the sale of a specific company back into the same company. The capital from the Fund can be used as a one time payment to the workers of the enterprise if they have not exercised their right to obtain shares. This payment is made by issuing securities of the enterprise or the Fund and can not exceed six monthly wage-bills of the enterprise.

C. OBJECTIVES

The objectives of the Law were obviously to encourage the transfer of ownership from the undefined category of "social-capital" to workers and managers, as a first step to deeper changes in the structure of ownership. Furthermore, this objective was intertwined with the macroeconomic stabilization policy implemented in December, 1989. One should keep in mind that the wage-freeze was expiring at the time and that the Federal Government attempted to control the wage bill by giving the firms the option of issuing either bonds or internal shares. The strategy consisted of linking the selling of internal shares with above-average profits so that wage hikes in profitable firms would be prevented.

Most importantly, the Federal Government was constrained by certain aspects of the still valid Constitution of 1974. The Constitution gives a whole spectrum of inalienable rights to the self-managed firms, including the right to use social capital without any interference. In particular, the state was prohibited from imposing changes in ownership on the self-managed enterprise. In practice, even loss-makers were exempt from the curbing of their self-management rights in the overwhelming majority of cases. It would be unfair, therefore, to criticize the Federal Government for limiting itself to only those ownership transformation strategies that were consistent with the Constitution which it had sworn to uphold.

The impossibility of altering property arrangements without the consent of the employees under the Constitution of 1974 meant that incentives had to be created so that self-managed enterprises would voluntarily embark upon privatization. It should also be kept in mind that the Law was the first of its kind, and the then prevailing philosophy of reform was linked to the existing socio-political reality and tradition of self-management. In other words, the assumption must have been that successful reform must start by recognizing certain existing institutional arrangements such as worker self-management as the starting point of deeper reform. This is an important point in all further privatization schemes since it should be recognized that self-management rights have become a part of what people throughout Yugoslavia have over the years come to consider as a part of their "natural rights". Privatization schemes will most probably have to be constrained by this fact, if they are to be viable. This means that employee buy-outs will almost certainly have to be a part of privatization strategies to some extent combined with worker participation or profit sharing schemes.

On the practical side, the internal share strategy was devised to bypass other problems as well. The strategy was seen as a way to avoid the problem of valuation as there was no capital market and not enough expertise to value the firms. It was also a way of getting around the problem of lack of investors in an economy drained of capital. The only available set of buyers were the employees who would buy-out enterprises on credit. In effect, the internal share strategy satisfied the mounting pressure to increase incomes by the purchasing of internal shares out of increments in employee incomes thus helping to constrain aggregate personal consumption and thus inflation.

D. WEAKNESSES OF THE FEDERAL LEGISLATION

The weaknesses discussed next should be considered in the light of the above mentioned constraints under which the Federal legislation was enacted and which the Republics could more easily ignore. The most important and obvious weakness lies in the fact that the existing laws do not provide for the complete and elimination of social ownership. The Social Capital Law allows the issuing of new shares only up to the amount of six annual personal income bills. Furthermore, they are extra shares which make it possible only to recapitalize the enterprise. Strictly speaking social capital is being reduced only through the "discounts" offered on the purchase of shares. These discounts can be thought of as additional free shares given to those who purchase the new shares issued by the enterprise.

This basically means that social capital can be eliminated only in those enterprises in which the value of social capital is rather small, so that it can be used up through the discounts. For example, assume that an enterprise has socially-owned equity in the amount of 100 and the average discount is, say, 50 percent. In other words, for every newly floated share that the employees purchase, they are granted one additional share out of the social capital. In this case the social capital would be liquidated if the value of new shares equals 200. Above all, the Law on Social Capital, along with the special Law on Personal Incomes and Collective Consumption, makes it possible to privatize only a part of the social capital.

Another weakness of the Law lies concerns the recapitalization of the enterprises in the process of privatization. This implies that every enterprise that is to be restructured with respect to ownership should at the same time be recapitalized. This is clearly inconsistent with the usual requirements of efficiency in the allocation of resources. It is certainly not the case that optimality requires that every enterprise should be recapitalized. Such an across the board policy clearly implies a misallocation of capital. Furthermore, the amount of this new investment is determined by the volume of capital that can be added through this peculiar privatization procedure.

The Law allows for social equity to be disposed of at book value. In cases in which the book value turns out to be excessive, the firms are allowed to initiate valuation procedures that are to be undertaken by specialized and authorized organizations under the monitoring of Republican restructuring agencies.

This is sure to result in unjust outcomes. In cases where book value is far below the "real" value, the buyers will be acquiring social capital at a bargain price. In cases in which the opposite is true, that is, where book value is overvalued, they will be acquiring it on terms which more closely approximate commercial standards. This will obviously violate the criterion of justice which should be given an adequate weight when it comes to privatization schemes in Eastern Europe and Yugoslavia.

The discount sale of internal shares may be seen as unfair for another reason. The public perceives some firms as being privileged as a consequence of previous macroeconomic policies and as a result of many other factors which have nothing to do with the real effort of the employees in those enterprises. Furthermore, former and present hiring procedures are not perceived as fair. In these circumstances, there is no reason for the present employees of profitable enterprises to be allowed to buy internal shares in their companies at large discounts.

Under the Law, the valuation of firms should be carried out under the auspices of Republican restructuring agencies. This adds another element that may hinder a fast and transparent process of privatization. The liquidation of social ownership might unfold under conditions which would be at variance with the prevailing attitude of the electorate. This can jeopardize privatization with the rekindling of populist sentiments. The Republican Agencies are empowered to drag their feet or put an end to privatization through the abuse of valuation procedures by claiming to protect social property to be disposed off at "unfair" prices.

Internal shares suffer from other disadvantages when they are used as the main component of a privatization strategy. They do not allow for sufficient mobility of capital. Bidding for the ownership of existing enterprises is rather circumscribed, and the valuation of the firms and the resources which they control is somewhat distorted. This will also bring inadequate macroeconomic effects, as those that are in a position to most efficiently use capital may not be in a position to obtain the necessary funds.

On a different plane, certain problems will arise due to the institutional setting and other prerequisites that are lacking. More specifically, quite a few enterprises have accumulated losses or have their balance sheets contaminated with items of doubtful value. Privatization, despite its decentralized nature, will not be successful unless balance sheets are cleaned up and a comprehensive and far-reaching financial restucturing program - including the rehabilitation of the banks - is thoroughly executed. If employee or former employee housing is owned by the enterprises, a separate strategy is needed to deal with this problem.

Probably the most important issue of corporate governance and employee motivation can not be adequately treated under the internal share strategy. The Law allows for the coexistence of different forms of property and thus retains worker management to the extent that enterprises undergoing ownership restructuring will still be partially socially-owned. The slow transformation through internal buy-outs will, therefore, not improve either governance or motivation in the short run, which given the state of the economy and mismanagement so far, is of vital importance. The Law will rather enable enterprises to continue in their old ways, thus failing to achieve an increase in efficiency that is so vital both at the micro and macro level.

Concentration of ownership of an enterprise in the hands of its own employees will most probably mean that employees will seek further guarantees in terms of job security. In short, the employees will most certainly use their ownership and self-management rights to keep down the level of lay offs that are a necessary part of a deeper restructuring processes.

All of the reasons mentioned above, clearly show that a more comprehensive, quicker and more transparent strategy is needed to launch a broad and deep process of privatization.

The empirical data on firms that undergone ownership restructuring using the Law is scanty. The only information that does exist comes from statements made by officials. According to official statements, 1,200 enterprises employing around 350,000 people have embarked on ownership restructuring under the Federal legislation. There is no data as to which types of firms or which industries have made use of the Law. Furthermore, there is no information concerning whether or not corporate governance has been improved in these firms, although that is an area difficult to assess in such a short time span. It seems natural to assume that ownership restructuring have been undertaken mostly in those enterprises that are considered to have potential by their employees and management. The evidence to support this assumption is simply not there.

ANNEX H

ANNEX H: OWNERSHIP RESTRUCTURING IN THE REPUBLICS

A. INTRODUCTION

In all Yugoslav Republics, there is an increasing awareness that social ownership, the cornerstone of the past socio-economic system, is inefficient and that it is the major cause of the present economic crisis in the country. The number of advocates of social ownership is decreasing. A rather influential group, however, particularly in the government of some Republics (e.g. Croatia and Serbia), are inclined towards nationalization of a considerable share of the economy as an alternative to social ownership.

B. LEGAL FRAMEWORK FOR PRIVATIZATION

It is interesting to note that there is no clear public program for privatization in the Republics. The governments of the Republics have never clearly spelled out their privatization intentions and objectives, the strategy of achieving those goals, methods and techniques of privatization, etc. The political situation in the country might be an explanation for that. Given the unstable political situation all across the country, Republics and their leaders most probably hesitate to initiate a clearly defined program for privatizing socially-owned enterprises. Accordingly, there is no document at the Federal of Republican level explaining the government's intention with respect to privatization, objectives to be achieved, time-span envisaged for their implementation, and so on. Thus far only the Federal government and two Republics (Croatia and Serbia) have enacted privatization laws. A privatization law was also prepared in Sovenia, but thus far was not enacted. In other Republics similar laws are being prepared. In the following sections we shall examine the two enacted Republican laws.

C. PRIVATIZATION IN CROATIA

The Croatian law on privatization was enacted in April, 1991.[1] Before the law was enacted a large part of the economy was nationalized (electricity, oil, railways, communications, etc.). The nationalized part accounts for some 40 percent of the value of the capital in the entire social sector of the economy (according to an official estimate made by the vice-president of the Government at the day of enactment of the law).

More social capital may be nationalized in the future. The law covers all socially-owned enterprises, except banks, other financial institutions, and insurance companies. The law sets a deadline for transforming social enterprises into joint stock or limited liability companies by the end of June, 1992. If they are not privatized by that date, the Republican Restructuring Agency will carry out their privatization. All social capital in the enterprises which is not privatized by the deadline will be transferred to the Republican Development Fund (two thirds) and pension and disability funds (one third).

The Agency is authorized to supervise and give approval to the privatization plans of the enterprises, except for those in which the value of social capital is below DEM 5,0 million. The privatization plan of an enterprise, submitted to the Agency, must include book value and estimated market value of its capital (the estimate may be made by the enterprise or authorized institution).

The Development Fund, a state-owned institution, will play an important role in managing the Croatian economy, since it is expected that the Fund is to own a large part of the shares in many enterprises. Provisions of the law give the Fund the right to participate in managing the enterprises but only on a limited range of issues. The Fund may withdraw from the enterprise only 5 percent of the dividends it is entitled to, and they must be reinvested in the same enterprise. The Fund is also obliged to offer all of its shares at

[1] "The Law on Transformation of Social Enterprises", *Narodne novine*, No.19, April 23,1991.

auction sales. All citizens are entitled to buy them at discount and pay for them in installments. The Fund may also offer shares to the employees in some enterprises at favorable terms or even free. The proceeds from the sale of shares are to be used by the Fund.

All shares issued by the enterprises in the process of privatization are ordinary shares except those which are sold at discount and/or paid for in installments. Those shares must be issued as personal shares and can not be sold until fully paid for.

The provisions of the law enable socially-owned enterprises to be privatized (transformed into private companies) in one of the following ways:

(1) the sale of all or part of the enterprise to workers, i.e. internal share issue;

(2) issuing new shares for the creation of new capital;

(3) dept conversion, i.e. debt-equity swap; and

(4) transfer social capital, in the form of shares or equities, to the Fund or pension funds.

The decision to privatize, including the selection and combination of methods to be used in privatization, shall be made by the managing body of the enterprise (workers council).

The first method seems to be of key importance since a large part of the law is devoted to it. This provision makes if possible both to sell the entire enterprise or a section of it and thus privatize the enterprise partly or completely by issuing internal (personal) shares.

The enterprise may be sold through auction or direct negotiation. The last option shall apply only if auction and tender fail. The starting price is the estimated value of the enterprise made by its managing body. If this price cannot be reached, the Agency may agree a lower price.

If the enterprise is being privatized by the sale of ordinary and personal shares, the workers and former workers of the enterprise, as well as all other employees in the social sector of the economy, state enterprises, and government administration, are granted a 20 percent discount plus one percent for each year of service. Workers and ex-workers of the enterprise enjoy a priority in purchasing the shares, but they are allowed to buy only up to 50 percent of the total shares issued.

All discounts are made at the expense of the social capital. Maximum period for instalment payments is five years. The rights of control are allocated according the amount of shares purchased, while the dividends shall be distributed in proportion to the part of the shares that have been actually paid for (increased by the value of discounts). Proceeds from the sale shall belong to the Fund, which is obliged to invest at least 50 percent of that amount in the commune where the enterprise is located.

According to the second method, privatization of an enterprise is possible by issuing new shares, as well as by transforming past direct investments (made by other enterprises or private persons) into equity shares. In the case of new share issue, the workers and ex-workers of the enterprise are granted the above mentioned discount, provided it does not exceed 40 percent of the social capital of the enterprise. Debt-equity swaps are subject of an agreement between the enterprises and their creditors.

The last method permits an enterprise to transfer its shares or equities to the Development Fund or pension funds. In this case, the workers of the enterprise would have first priority in purchasing these shares, if they are later to be sold by the Fund and pension funds.

D. PRIVATIZATION IN SERBIA

The Privatization law in Serbia was enacted in July, 1991.[2] It is rather similar to the Croatian law. As in the Federal and Croatian laws, the decision to privatize is to be made by the managing body of the enterprise (worker council). The law favors voluntary and decentralized privatization, what means that the enterprises themselves are to decide when and how they are going to be privatized. They are also free to decide whether they are going to be transformed into joint sock companies, limited liability companies, etc. Consequently, there is no provision in the law specifying a deadline for privatization.

The law does not allow privatization of enterprises in certain economic sectors (electricity, oil and gas, railways, post, telephone, etc.), subject to enactment of a separate law which would stipulate which enterprises in those sectors are to be nationalized. The law also does not apply to the banks and financial institutions. According to the official estimate of the Government made public at the day of enactment of the law, the intention is to nationalize 25 percent of socially-owned capital.

As in the case of Croatia, the Privatization Agency and the Development Fund play a central role in the privatization process. The enterprises have to inform the Agency about their plans to privatize, and submit to it data about the value of social capital, valuation method used, discounts allowed, etc. The Agency has to give a positive opinion on the conformity of the proposed ownership transformation with the existing laws. The value of social capital is to be determined in accordance with the balance sheet of an enterprise. The Agency is also authorized to examine privatization plans of the enterprises adopted previously in conformity with the Federal law. Its power to suspend those plans, if the provisions of the Federal law are not strictly respected, was amended in December, 1991. Instead, the Agency is now in a position only to order strict fulfillment of the provisions of the Federal law.

Serbian law allows the following privatization methods to be used in transforming social enterprises into private and mixed ownership companies:

(1) sale of enterprises by issuing internal shares;

(2) issuing new shares for acquiring new capital;

(3) debt conversion, i.e. debt equity swap;

(4) selling the entire enterprise or a section of the enterprise;

(5) contracting-out and leasing social property to a private entrepreneur; and

(6) transfer of social capital, in the form of shares, to the Fund and pension funds.

For the purpose of issuing internal shares, the enterprise is to determine the value of social capital on the basis of its book value. An external estimate of the value of the enterprise is required only in specific situa-

[2] "The Law on Transferring Social Ownership into Other Forms of Ownership", Official Gazette of the Republic of Serbia, No. 48, August 5, 1991.

tions (if the rate of profit is high, if valuation methods used are not proper, etc.). Internal share privatization may start if employees have subscribed to at least 10 percent of the social capital of the enterprise, and each manager subscribes to buy shares in an amount equal to the sum of their net wages in the last two years.

In this first round of subscription for internal shares, the workers and ex-workers of the enterprise are entitled to a 20 percent discount plus one percent for each year of service in the enterprise. The amount of shares sold at discount cannot exceed one-third of total value of the social capital of an enterprise. Discount is granted only to the current and former employees of the enterprise.

In the second round, the enterprise is obliged to offer the remaining internal shares for sale without discount by public invitation. If it happens that some shares remain unsold in the second round, the enterprise may offer them for sale at discount in the third round. The buyers are offered the same discount as in the first round.

The shares can be bought in full for cash immediately or in installments. If paid for in installments, the repayment period is five years. In this case the first payment shall amount to at least 20 percent of the shares bought, while the remaining payments will be adjusted for the increase in retail prices.

The law limits the amount of shares that can be bought at discount to DEM 20,000. If the workers in the enterprises decide to buy shares in the third round also, this limit is DEM 30,000.

The second privatization option offers the possibility of privatizing a socially-owned enterprise, i.e. transforming it into a company, by issuing shares in order to acquire additional capital. In that case, the estimate of the value of enterprise has to be done by the Agency or authorized firm.

The law also provides for the possibility of selling the entire enterprise or a part of it. If a socially-owned enterprise is to be sold, it shall be done by auction sale or tender. The proceeds from the sale shall belong to the Fund.

A specific feature of the Serbian law is that it enables the privatization by contracting-out and leasing arrangements. The intention is to use this method for privatizing small firms and shops.

The proceeds from the sale of shares without discount shall belong to the Fund (60 percent), pension funds (30 percent), and employment fund (10 percent). At the same time, 50 percent of the proceeds from the sale of shares at discount shall belong to the Fund, while the rest is to belong to the enterprise.

The Development Fund plays an important role in the privatization process. As in the case of Croatia, the law makes provision for a substantial part of social capital to be transferred to the Fund. The Fund is obliged to transfer part of that capital (30 percent) to pension and disability funds. The Fund is to use its resources (capital) for financing restructuring and consolidation programs of the enterprises as well as for direct investments.

E. WEAKNESSES OF THE REPUBLICAN LAWS

The Federal and Republican laws are similar in the sense that they favor an internal share privatization strategy. Accordingly, their basic shortcomings are also the same. The main difference between the Federal and the Republican laws is twofold. First, the Republican laws offer more privatization options or methods to the enterprises. Second, the Republican laws also provide for the nationalization of socially-owned capital (enterprises).

By increasing the available privatization options, the Republican laws remove some of the weaknesses of the Federal law. The debt-equity swap option in the Republican laws makes possible a transfer of social capital to institutional owners, which in turn stimulates the creation of financial intermediaries and diversification of capital market structure. The contracting-out and leasing options will certainly stimulate so called small-scale privatization, i.e. privatization of shops and other small and medium scale social enterprises.

At the same time, both Republican laws show rather clearly the intention of their governments to nationalize a large portion of social-sector enterprises. The weaknesses of state-owned enterprises are well known. Since the State is inferior as the owner in comparison to a private owner, State-owned enterprises tend to be less efficient than privately owned enterprises. If a large part of the Croatian and Serbian economies are going to be nationalized, the potential efficiency of these economies would tend to be reduced. This might become a serious developmental bottleneck for both Republics.

The long-run intention of the two Republics in respect to ownership of their economies is not known, and thus it is not possible to say why they wish to nationalize such a large part of existing social enterprises and what they intend to do with such a large number of state-owned enterprises. As for now, both Republics are nationalizing only very profitable enterprises (oil, gas, electricity) and those that form the backbone of their economies (the enterprises of special social interest, as they are called). This seems to indicate that the main objective of nationalization might be the desire to appropriate the profits of state-owned enterprises, since this source of revenue can substitute for tax revenue. If this is the case, it could be beneficial to the economy in the short and medium run because the general level of government taxes could be lower than what would otherwise be the case. Lower taxes consequently will tend to stimulate saving and investment and faster economic growth. But in the long run, those beneficial effects would disappear since State-owned enterprises often become inefficient and thus large loss makers. Some nationalizations in the two Republics (road and water management, air transport, and public utilities) indicate the intention of the governments to provide low priced services in those economic sectors in which natural monopolies are likely to exist.

With regard to nationalized enterprises, it is hoped that the long-run intentions of the Republic governments are, first, to restructure the enterprises it owns and, second, to sell them later on (following, for example, French experience with a stable core owner).

The Republican laws also strongly favor the sale option in privatizing social sector enterprises. This privatization strategy has two obvious shortcomings:

(1) sale would take too long time, and

(2) the end result would be highly dispersed ownership.

If the Republics do not change their privatization strategy in the near future, they are likely to face two problems. The first concerns the introduction of efficient corporate governance, what is unlikely to appear if share ownership is to be highly dispersed. Since the capital market at present does not exist, the process of concentration of share ownership is going to be long lasting. If, on the other hand, corporate governance in Yugoslav enterprises is not going to be introduced rapidly, economic efficiency is not likely to improve. In that case development prospects of the economy would remain poor.

The second concerns the ability to sell social capital rapidly. This is not likely unless the enterprises are allowed to underestimate substantially the value of their social capital or offer more favorable discounts to the workers. This is because the accumulated savings of the population is small and not ready available for new investments. State banks are in fact bankrupt; and if the citizens withdraw their deposits from the banks, the government would have either to print new money or to borrow from abroad. Also future savings are uncertain. The prospects for inflow of foreign capital (direct private investments from abroad) are also poor for the time being. The only viable solution for the success of internal share privatization strategy would be to offer more favorable discounts to the workers.

Available information suggests that the workers have little interest in buying internal shares if the valuation of the social capital of enterprises is done under the control of the Restructuring Agency. The workers do not have much interest in becoming internal investors if it means that they have to cut down their consumption substantially.

Another indication of the same problem comes from the privatization program in Vojvodina. About 17 large socially-owned enterprises were to be privatized by a mixed method (debt-equity swap and transfer of social capital to institutional owners). The workers did not show much interest in buying internal shares to generate additional capital even though the enterprises badly needed new capital.

The experiment in Vojvodina is in the process of implementation, so that it is too early for firm conclusions. The whole idea behind this privatization scheme is to introduce quickly corporate governance in a number of large enterprises in Vojvodina and improve their efficiency. The Government there believes that it can be achieved by transferring social capital to better owners. The transfer is partly to be done by debt-equity swaps and partly by direct transfers to institutional owners. It is hoped that institutional owners will be more motivated to make their capital profitable. If this experiment is successful, it might influence future privatization steps in Serbia, as well as in other parts of the country.

F. THE OBJECTIVES OF PRIVATIZATION

As we have already mentioned, privatization objectives in Yugoslavia have never been clearly spelled out. The need for the privatization of social capital (usually called ownership transformation) was publicly explained in general terms as a desire of the government to make the economy more efficient and to introduce an economic system similar to that in developed Western economies. More elaborate and specific privatization objectives have never been defined. This is equally true for the governments at the Federal and Republican levels. Based on the enacted privatization laws, we can speculate as to what these objectives might be.

It appears that one privatization objective is to redistribute the social property to those workers who have practically owned it all along. Selling social capital at favorable discounts to the workers in the enterprises seems to be a good instrument of achieving this objective as well as some other economic and social objectives. It might also represent a desire of the government to buy the support of the workers for economic and social reform. Since a large portion of the population would become owners of enterprises, they are less likely to obstruct market oriented reforms.

Another objective might be a desire of the government to motivate internal owners (workers and managers) to manage the enterprises better. The internal owners would have an interest in making their enterprises profitable, since they are allowed to pay for the shares out of future dividends. If internal owners are able to make these enterprises profitable, this would achieve two privatization objectives of the government. Because the enterprises are going to be predominantly in mixed ownership with a large proportion of shares remaining in social ownership, the government will also benefit if the enterprises become profitable. Since the dividends on social capital belong to the government (the Fund), its revenue will also increase. If the internal owners make enterprises profitable, the benefits will be enjoyed by both the owners of private capital (workers and managers) and the owner of social capital (the state or the Fund). For that reason the Republican laws allow the workers to buy the shares in installments and pay for them out of future dividends.

Another privatization objective could be a desire of the government to recapitalize socially-owned enterprises. For a number of years Yugoslav enterprises have been illiquid. Accordingly, the idea of the government was to motivate the internal owners to increase the profitability of enterprises and reinvest the profits in the same enterprise (paying for the shares in installments). For the same reason, the Development Funds have been also obliged to reinvest their share of dividends paid by a particular enterprise either in the same enterprise or in the commune in which the enterprise is located. In this way, it was expected that, the enterprises would be supplied with additional capital needed for normal production. There will be no need for the government to intervene and supply the enterprises with capital. The problem is how fast the enterprises will get additional capital by the sale of internal shares. If new capital does not come fast enough, this privatization strategy will not solve the illiquidity crisis.

Most probably, the government had an intention to achieve another objective by the same mechanism. Namely, if the workers as share-holders are to be motivated to increase the profits in their enterprises as well as to reinvest all dividends belonging to them, the problem of wage distribution and income policy will also be solved. The Yugoslav economic system was unable to solve this problem since the beginning of the 1960s.

The idea seems to be to make the workers, in their role of share-holders or internal owners, motivated to maximize the profits of their enterprises rather than only attempt to increases wages. In this way they will impose self-restraints on their own wages in managing the enterprises, but will also increase the amount of savings out of their total available income.

Accordingly, the new mixed economic system, which is to be created in the process of privatization, will be endowed with two features which the old system did not have. The new system will impose wage restraints by consensus or by self-interest and will tend to increase the rate of saving. To what extent those expectations of the government are to be fulfilled is unclear. For the time being there is no evidence that the workers have an intention to behave in this manner.

G. CONCLUSION

Authorities in Serbia and Croatia have offered very similar concepts of ownership restructuring for social enterprises. The main features include:

(1) sale of enterprises instead of free distribution of the social capital;

(2) decentralized instead of a centralized approach;

(3) dominant employee shareholding instead of outside owners;

(4) relatively fast creation of an incomplete ownership structure (both private and social-ownership in the same enterprise), and

(5) afterwards, its gradual completion.

Such a concept does have certain advantages, such as collection of revenues by the government, relatively wide dispersion of ownership, possibility to create in a relatively short time the management structure in some enterprises based on an (incomplete) private ownership, etc.

However, shortcomings are major and probably outweigh the advantages. The shortcomings include:

(1) insufficient volume of domestic capital;

(2) slow privatization of a large number of enterprises;

(3) possible crowding out of private savings;

(4) the Funds becoming the dominant source of capital in the economy;

(5) difficulties with the estimate of enterprises' value;

(6) control of the enterprises by inside investors;

(7) reproduction of the former social structure in a new era;

(8) slow creation of a capital market as the consequence of a large proportion of shares being internal and not paid for;

(9) possibility that the state might inefficiently use proceeds from privatization; and

(10) nationalization of a large segment of the economy.[3]

[3] See Korže and Simoneti (1990).

ANNEX I

ANNEX I: FREE DISTRIBUTION TO CITIZENS

Considerable conceptual and technical weaknesses of privatization through sale of social property urge us to look for an alternative solution, which would establish clear ownership rights in a faster and more equitable way. One such concept is free distribution of former socially-owned property to all citizens of a country. In this way undefined ownership rights of individuals inherent in social ownership is replaced by well defined individual ownership rights. At the same time, such a system of ownership transformation would probably be regarded as fair to all citizens.

One possible alternative is the free distribution of ownership only to employees in enterprises that are being privatized. An advantage of this procedure is that it is fast and simple because it avoids all the technical difficulties arising from the sale of an enterprise or free distribution to all citizens.

However, there are pronounced weaknesses of this concept. The first one is its extreme unfairness. Citizens would fare very differently depending on whether they work in a sector that is being privatized, whether they work in profitable or loss making enterprises, whether they are active or retired, whether the capital-labor ratio in the enterprise is high or low, etc.

The other shortcoming[1] is the emergence of enterprises in which inside investors are the only owners, so that some characteristics of the self-management system would be preserved.[2] Raising capital would be difficult since outside investors would not be willing to invest in an enterprise owned by employees because the latter are motivated to syphon a greater portion of income or profit into their own salaries and are in a position to do so.

A. DIRECT DISTRIBUTION OF SHARES

Transfer of ownership rights to all citizens can be carried out in two ways - through the distribution of "vouchers", and by direct distribution of shares to citizens. The free distribution of shares to individuals is impossible without being unfair because of the difficulty in valuing the shares to be distributed to ensure that everyone receives the same value. Thus it is necessary to establish some mutual bond between the shares of all enterprises. Edgar Feige thus proposed for the Soviet Union the privatization scheme under which each citizen would receive composite shares of an aggregate of industrial enterprises. In other words, such a share would entitle each citizen to a portion of each enterprise's property, while dividends would be paid on the total, i.e. based on average profitability.[3]

The weaknesses of the concept is that if everybody owns everything, then no one owns anything. The efficient management of enterprises can not be achieved and the capital market cannot rest on composite shares, so that they have to be unpacked into distinct components in order to establish true ownership.[4]

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[1] See Lipton and Sachs (1990. p. 25).

[2] Experience of Mondragon co-operatives, which are based on the same principle, is not encouraging.

[3] See Borensztein and Kumar (1991. p. 5).

[4] See Dhanji and Milanović (1990. p. 27).

B. DISTRIBUTION OF VOUCHERS

The best option for the free distribution of state/social ownership is based on the use of vouchers (certificates, coupons). The state would give vouchers to all citizens. They could use the vouchers to purchase shares of the state/social property. Vouchers would make up for the lack of purchasing power in Eastern European countries.[5]

Previously giving away shares was used in the case of one state company in the Canadian province of British Columbia and two leading banks in Chile.[6] Vouchers are already included in the privatization laws of the Czech and Slovak Republic and Rumania and are being seriously considered in Poland.[7] About 50 percent of state enterprises in Czechoslovakia may be privatized through vouchers.[8]

C. METHODS OF AUCTION

A major decision that has to be made by the state concerns the way individuals express their preferences to own shares in enterprises using vouchers. We will here describe three methods:

a) In a "Dutch" auction, each company's shares would be offered to the public at a high initial price which would not be attractive to anyone. Afterwards, the price of shares would be decreased in steps after certain time intervals. At each step, holders of vouchers would be able to buy shares at the offered price in exchange for vouchers. The price reductions continue until all shares of a given enterprise are "bought".

b) Another variant of the Dutch system is simultaneous tender for a larger number of enterprises. Holders of vouchers would submit their offers to purchase shares of enterprises: e.g. citizen X would like to buy Y shares of enterprise Z at the "price" of W dinars per share. Every seven days, the press would quote the average "price" of enterprises, and citizens have the right to send new, higher quotations. It is forbidden to withdraw quotations supplied earlier.

   After the completion of the submission process, shares will be given to citizens who quoted the highest prices per share. If the demand for shares of a certain enterprise fell short of the number of shares offered, the remaining shares are canceled.

c) In a pro-rata system, each citizen offers the number of vouchers he wishes to allocate to certain enterprises. Shares of each enterprise are distributed to each citizen depending on the quantity of

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[5] Free distribution can be made in another way too: a small number of intermediaries - holding companies - become owners of enterprises, and their shares are then distributed free to all citizens. More about this system in a section on holding companies.

[6] These banks have been privatized through interest-free loans granted to buyers by the state and so favorable investment tax credits that shares were practically free. Concentration of ownership was prevented, because trading of shares within 5 years led to loss of the mentioned benefits. See Luders (1990).

[7] See Borensztein and Kumar (1991. p. 5).

[8] See Milanović (1991. p. 6).

vouchers which he or she has offered, relative to the total quantity of vouchers offered for a given enterprise.[9]

$$D = S\frac{I}{T}$$

where D stands for the number of shares of enterprise Z sold to citizen X, S is the total number of shares in the enterprise Z, I is the number of vouchers offered by citizen X for shares of enterprise Z, and T is the total number of vouchers offered by all citizens for enterprise Z.

Each of these systems has advantages. The first type of "Dutch" auction offers individuals the greatest freedom of choice, because they alone decide on the number of shares they are going to "buy". The second type ensures a semi-iterative procedure, so that each individual can react to moves of others by adjusting upward his quotation. The pro-rata system is the simplest and ensures that all shares of each enterprise are used up.

An important issue is whether auctions (tenders) for privatization should be organized only once or in several independent stages. A one-off tender reduces administrative costs and accelerates the entire procedure. In contrast, a multi-staged auction with smaller numbers of enterprises for sale makes it easier for citizens to get to know the enterprises and therefore estimate their value more reliably.

It may be best to organize a one-off auction, but to extend the period for submission of bids for several months, so that citizens would have enough time to make up their minds.

The next issue is whether trading of vouchers between citizens should be allowed or not. The usual argument against transferability of vouchers is that they are close substitutes for money and the resulting increase in liquidity encourages consumption and inflation. Trading of vouchers could be banned if the authorities assess that their trading at low prices would essentially disturb the social or national balance.

Arguments in favor of transferability of vouchers are that this would permit greater freedom of choice, and concentrate vouchers in the hands of a smaller number of people who truly wish to be owners? Transfers would help ensure a better ownership structure and thus better management of the enterprise.

D. SPECIFIC PROPOSAL

Vouchers have been advocated for Yugoslavia.[10] Let us consider the way privatization of socially-owned enterprises could be carried out in Yugoslavia through free distribution of vouchers. Initially those enterprises which are to be privatized should be selected. Since the voucher option is complex and hard to repeat, it would be good to decide at the very beginning about the scope of privatization.

Furthermore, a booklet should be published giving essential data on all enterprises such as the book value of fixed assets, number of employees, indebtedness, balance sheets for several recent years, etc. In this way, citizens could get some idea about the value of such enterprises.

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[9] See Triska (1990. p. 9).

[10] For example, see Mijatoviċ (1990).

In the next phase, each adult citizen would be given free an equal number of vouchers with a fixed nominal value. Vouchers replace money at auctions for purchase of shares. Trading of vouchers between citizens could begin as soon as they are distributed.

Assuming the second type of Dutch action described above, all citizens would submit their quotations to the Center for Privatization within three months. They would quote how many shares of which company and at what price they would be willing to buy with their vouchers. In this way citizens would express their preferences and assess the value of individual enterprises. During this period the mass media would announce the current quotations of share prices.

After the period for auction expires, quotations submitted would be aggregated and shares distributed according to the following criteria. If demand exceeds the available number of shares for a given enterprise, shares would be awarded to those citizens who quoted the higher prices per share. Should the demand for shares of an enterprise be below the supply, total demand would be satisfied and the remaining shares canceled.

This would be followed by distribution of shares to citizens and establishment of a stock market to permit the resale of shares. After privatization, foreign investors could buy shares from citizens.

This system of free distribution could encompass most of the shares. A portion of shares of each firm could be offered to employees at a preferential price in order to reduce resistance to privatization.

E. ADVANTAGES

Advantages of this system of privatization of the social sector are:

- clear ownership rights by individuals would be established, which is an important objective of every privatization effort,
- equal opportunity for all citizens to own shares. All citizens would receive an equal value of vouchers and therefore have an equal chance to acquire ownership of the present social property. This would lead to wide dispersion of private ownership, which expands and protects individual rights and freedoms,
- the state role in the privatization procedure is mainly technical. In addition to making the list of enterprises to be privatized, the state would print the vouchers, and assist in their trading. In particular, the state won't be able to waste money acquired through privatization or discriminate against certain enterprises or individuals,
- speed of privatization. Privatization of a large portion of the social sector and the establishment of a stock market would probably take no more than a year, which is faster than most other types of privatization,
- a stock market would be created quickly. This would be very useful for later economic development.
- pricing of shares and determination of each firm's value through bidding. This helps avoid the many technical and conceptual problems of estimating the value of enterprises inherent in other methods of privatization.

- the entire capital gain from increased efficiency will be appropriated by domestic citizens. Privatization will increase the efficiency of social enterprises and thus ensure an increase in their value. Since Yugoslav citizens instead of foreigners would become the owners of privatized enterprises in the first round, the capital gains will go to them. Foreigners are much more likely to receive these gains if enterprises are sold, because underpricing could be expected to occur due to the insufficient liquid assets of individuals,

- misappropriation of social capital will be prevented. This occurred in Poland or Hungary, where the managers bought the best parts of enterprises at low prices and thus made a fortune at the expense of the state and other citizens,

- citizens have a stake in and thus support privatization. They acquire a portion of the present social property without any charge.

F. DISADVANTAGES

There are some problems with a voucher system that need to be discussed. One of the problems is that there is no valid preliminary assessment of the value of enterprises. Therefore, bidders may face considerable difficulties in assessing relative value and thus choosing between numerous alternatives. Consequently, many individuals may not be able to make a good choice, while the better informed ones - perhaps managers - could purchase shares at low prices. However, it is worth pointing out that this problem is less than the problem of assessing each firm's value in the case of privatization through sale.

This difficulty may be partly offset by publishing all available relevant information on all enterprises (book value of assets, debts, number of employees, recent balance sheets, etc.) and through financial analyses published by the press. Furthermore, the main principle underlying free distribution is equal opportunity for all citizens instead of equality of final results.

A frequently quoted argument against the voucher system is that it might push up inflation and private consumption because vouchers are partial substitutes for money. This argument is valid only under certain, rather restrictive assumptions. Vouchers would not increase the money supply, and only money serves as the final means of payment. Indeed, sale of vouchers for money in order to buy goods only transfers purchasing power from one person to another and does not necessarily increase consumption and prices. In order to increase consumption, it would be necessary for sellers to have a higher propensity to consume than buyers. This is possible but not very likely in view of the rather even income distribution in Yugoslavia.[11] Moreover, one could try to mitigate the problem by a simple trick, which should confuse citizens and hinder buy/sell transactions: vouchers need not be nominated in dinars but in "points", so that any connection with money will be apparently removed.

Another reason why the voucher system might increase consumption and thus inflation is that vouchers are an increase in wealth even to those who don't sell them. Thus the perceived need to save may be reduced and thus consumption increased.

G. CORPORATE GOVERNANCE

The main argument against the free distribution of social/state capital is that it would not improve corporate governance. The ownership resulting from such privatization would be extremely dispersed. Owners would

[11] See Pohl and Hinds (1991. p.18).

not have enough incentive to appoint capable managers and control them efficiently. The problem is of a "free rider" type. The absence of a dominant shareholder allows inapt managers to retain their positions or managers to pursue a business policy in their own interest instead of the best interest of the enterprise and shareholders. Such an outcome defeats the basic objective of privatization, namely improved corporate governance and management.

Thus Kornai[12] finds that in an extreme dispersion of ownership "quite impersonal state ownership would be replaced by an equally impersonal private ownership". Similarly, Blanchard et al.[13] conclude that "small shareholders exert little control over management. While they could in principle monitor managers, and replace them with better ones, the evidence is that they lack the expertise and are unable to achieve the coordination to do so. Proxy fights, in which a majority of shareholders votes to acquire a majority of seats on the board, are rarely successful. While takeovers, or threat of those, could in principle force management to be efficient, they are relatively rare when shareholding is diffuse."

Other factors, however, suggest that corporate governance will be improved despite an initial dispersion of ownership. The capital market is a good indicator of enterprise performance, so that low or declining share prices point to poor business management. This can lead to a possible takeover of the enterprise by new owners. However, a certain period of time is necessary to establish a stock market in the former socialist countries. During that period, price signals from the capital market may be unreliable.

The threat of takeover by other investors remains a realistic possibility, even though that shares are dispersed. Also the possibility of bankruptcy, means that managers have an incentive to work in the best interest of the company in order to safeguard their job and position.

Additional incentives for efficient management may be provided by long-term remuneration of managers through stock options or tied to stock prices or some other indicator of management efficiency. Other mechanisms are possible to ensure efficient management including a detailed and modern accounting system, precise responsibility rules, a high dividend policy, and credit financing, etc.[14]

Further concentration of ownership and reduction of the number of owners through trading of shares is probable in the period following privatization. It is impossible to estimate how fast this concentration will proceed, but some indication may be provided by an example of some privatized firms in the United Kingdom. The number of shareholders of British Aerospace declined within a year from 150,000 to 27,000. The rate of decrease for some other privatized enterprises (Amersham, British Gas, British Telecom and British Airways) ranged between 12 and 75 percent per year.[15]

Another option is for the state to hold a certain portion - say, 20 percent - of shares of each enterprise undistributed, which would be sold to one owner or an organized investment group. This would ensure the existence of a dominant shareholder and solve the problem of efficient enterprise management, in spite of possible wide dispersion of other shares.

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[12] See Kornai (1991. p. 42).

[13] See Blanchard, Dornbusch, Krugman, Layard, and Summers. (1990. p. 57).

[14] See Pohl and Hinds (1991. p. 17).

[15] See Milanović (1991a).

This idea has been borrowed from the French privatization program in the 1980's. In order to mitigate the problem of insufficiently developed capital market and lack of investment banks, the French government developed the "stable core" concept. Individual or group investors submitted their bids for 20 or more percent of ownership. In choosing the winning bid, the state took into account not only the size of the bid but also the investor's reputation, his financial strength, future business policy, etc.[16]

Concentration of the entire ownership in the hands of a small number of loosely controlled holding companies or other institutions can also cause problems. Such extreme concentration may renew the former "production ministries" and increase bureaucratization, with all accompanying inefficiency.[17]

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[16] See Lipton and Sachs (1990. p. 35-36).

[17] See Borensztein and Kumar (1991. p. 12).

ANNEX J

ANNEX J: BANK REHABILITATION

A. CURRENT OWNERSHIP AND CONTROL OF BANKS

According to a set of "self-management" laws enacted in the mid 1970's, banks were defined as a non-profit financial service for the "productive" social sector enterprises. If this definition was strictly adhered to, banks in Yugoslavia would simply be credit cooperatives owned by "founding member" enterprises. However, extensive state involvement (over and above its role in setting monetary policy) has considerably broadened the scope of that definition. The real-life activities of the banks were brought close to the standard activities of commercial banks in Western countries. They collect deposits from the general public and borrowed from foreign sources.

The state was involved both formally and informally in directing the activities of banks. Formally, the state guaranteed foreign creditors and insured domestic dinar and foreign exchange deposits. Informally, it appointed most bank managers and influenced bank decisions. Until recently, the most important involvement was that the state prevented entry of domestic private banks and foreign banks.

The empirical evidence on sources of bank equity capital and loanable funds suggests that the constitutional definition of the "ownership of banks by enterprises" has little support. Yet, the initial legal definition of banks and their "ownership by enterprises" was retained and turned into "bank control by enterprises". This control was exercised through appointed representatives from "founding member" enterprises to bank credit and management boards. Officially, the enterprise representatives were stockholders or "founders" of commercial banks although they in fact never invested any capital in these banks. Coordinated action by the state and large enterprises on the bank boards has influenced most credit decisions in the past.

B. CAUSE OF BANK INSOLVENCY

Over the years, bank boards have made a number of decisions on credit allocation and use of retained profits (distribution to "founders") which have influenced the financial structure and solvency of the banks. As a result, huge net capital losses are presently hidden in the books of commercial banks. This leaves the legal property rights and ownership of banks very unclear. The complex ownership problem cannot be fully understood if the state's prior involvement in the functioning of the formally decentralized self-management system, which mostly took place through activities of the commercial banks, is left out of the picture.

Although the state cannot appropriate directly any enterprise profits into the budget or finance enterprise losses from the budget, the state has frequently exercised the "right to mediate" the financing of social enterprise losses through the banking system. Government appointed bank managers and large enterprise representatives on the boards of commercial banks made decisions to "rescue" important social-sector enterprises by financing their losses.

The rescue operation could take a number of creative, non-transparent forms. These included postponed interest payments, revolving short-term credit used to pay interest to the bank, assumption of "foreign exchange losses," or embarking on new investment projects in order to obtain ample, long-term loans which would help companies "invest their way out of current problems".

In acquiring preferential bank treatment, the importance of an enterprise was derived from:

- its size (as indicated by its number of employees);
- the politically established strategic importance of the sector (priority industries like steel, metal-processing, and electronics); or

- simply the political backing of the enterprise and its success in lobbying.

Requests to finance losses of small and medium sized companies were often turned down. When they were honored, it was by local branches of commercial banks as a result of "mediation" by local governments. The bigger the company, the more important was the role of the state in assuring that the company's losses were financed by the banks. For the largest companies, Republican governments were directly involved in negotiating financial arrangements with the banks. The existence of a fairly concentrated banking system throughout the 1970's and 1980's provided an ideal institutional forum for deciding, usually secretly, on investment and loss financing.

This whole activity was orchestrated by the state and performed illegally through the banks. In other socialist countries, where enterprises are directly state-owned, it was perfectly logical for these losses to be financed directly through the state's budget. This is a more open and transparent process than occurred in Yugoslavia.

As long as workers' remittances and new foreign capital (loans) were coming into Yugoslavia prior to the international debt crisis of 1982, the use of long-term subsidized foreign loans was the main vehicle for bank subsidies to enterprises. When this source started to dry up and commercial banks couldn't accumulate more bad debt, there was a pressure to transfer out of the banks some of that bad debt. The most logical and transparent instrument to deal with the problem -- transforming bad bank loans into public debt -- was again politically off limits. Instead, the National Bank of Yugoslavia has partly assumed "qualified losses" from individual commercial banks (mostly in the form of foreign exchange losses).

Table 18 Regional distribution of negative net capital.

Republics/Regions	Percent
Bosnia and Hertzegovina	15.2
Croatia	11.5
Macedonia	6.4
Montenegro	3.4
Slovenia	2.5
Serbia proper	49.8
Vojvodina	2.4
Kosovo	8.8
TOTAL	100.0

The majority of bad loans have stayed with commercial banks as is clearly indicated by the available data on bank income statements and balance sheets and the analysis of the financial situation of Yugoslav banks. This analysis was done by the Social Auditing Service and Coopers & Lybrand, Deloitte as part of the Yugoslav Banking System Restructuring Program prepared by the National Bank of Yugoslavia. In this and subsequent sections, we will draw on relevant conclusions from that report. Due to the confidential character of individual bank data, such data cannot be quoted in this paper.

At the end of 1989 when the analysis was done, the Yugoslav banking system had a very heterogenous structure across regions. In complying with the new Banking Law, banks have adopted different strategies in different regions (Republics and provinces). Thus in Croatia, Slovenia, Bosnia and Hertzegovina, Vojvodina, and Macedonia, former "associated" banks were broken up into the same commercial banks that existed in the late 1970's prior to politically orchestrated integration (22 in Croatia, 17 in Slovenia, eight in Bosnia and

Hertzegovina, five in Vojvodina and two in Macedonia). As a rule, the core of former associated banks continued to exist as an independent commercial bank.

Table 19 Bank bad debt relative to assets and deposits.

Republic/Region	% of total assets	% of total deposits
Bosnia and Herzegovina	41.1	77.4
Croatia	25.2	47.6
Macedonia	37.4	57.9
Montenegro	70.9	182.5
Slovenia	14.5	29.3
Serbia	45.6	62.7
Vojvodina	23.8	48.3
Kosovo*	166.7	351.2
Yugoslavia	34.0	58.0

* The potential losses in Kosovo are greater than total assets since bad debts include certain bank guarantees.

In Serbia, Montenegro, and Kosovo, however, former associated banks were only legally transformed to comply with the new legislation and little decentralization occurred. Only a few small banks were spun off (three in Serbia, one in Kosovo and one in Montenegro). Overall, 63 banks were operating in Yugoslavia during 1989 and their total assets (excluding interbank transactions) amounted to an equivalent of $35 billion. Almost half of this ($17.2 billion) was lent to enterprises. On the liability side, banks had received $30.6 billion in deposits and their equity amounted to less than $4 billion. Bank income, however, was down (most banks had large losses) and most of the loans to enterprises had been in default.

When the portfolio of bank loans was analyzed, it turned out that about 70 percent of these loans (or $12 billion) had to be treated as a potential loss (bad debt) against which reserve provisions should be made. After accounting for these provisions, the banking system as a whole has negative net capital of some $8 billion. Negative net capital is present at the regional level (Republics and provinces) as well although it is quite unevenly distributed (see Table 18).

When we look at the solvency of individual banks, only 17 out of the 63 banks had adequate capital after provisions for reserves against risky assets were made. Another seven banks have positive but insufficient capital while 41 banks have negative capital.

A somewhat different picture of the insolvency of the banking system emerges when inadequate capital numbers are compared with the value of total assets and the value of bank deposits both for the nation as a whole and for particular Republics and regions (see Table 19). By this measure, Slovenia, Croatia, and Vojvodina have the least amount of bad debt relative to the size of the banking system.

C. RESTRUCTURING PLAN FOR THE BANKS

The National Bank of Yugoslavia restructuring program for the Yugoslav banking system started from this analysis of the financial position. Without going into the methodology used, the National Bank classified banks into three groups:

- Group I are completely insolvent banks which need to be either closed down (small or medium banks) or immediately restructured (large banks).
- Group II are insolvent banks which need to be restructured immediately following large banks in Group I.
- Group III are solvent banks which need not be restructured but may need some liquidity and income generation boost.

The three groups can be further broken down by bank size (see Table 20).

Group I banks hold most of the total bad debt (see Table 20). The five large banks in that group alone hold 57 percent of total bad debt. The banking system restructuring program claims that these banks will have to be restructured as soon as possible, followed by medium size banks in Group I. The small banks in Group I,

Table 20 Categories of banks

	Group I	Group II	Group III
Large banks	5	3	1
Medium banks	8	6	3
Small banks	6	11	20
Total	19	20	24
Proportion of Bad Debt	83.5%	12.6%	3.9%

which hold five percent of bad debt, will probably have to be closed down.

Group II banks are scheduled for individual restructuring programs immediately following Group I banks. Finally, 24 Group III banks hold only a small proportion of total bad debt and they are not scheduled for individual restructuring.

Based on this diagnostic assessment of the banking sector, detailed bank restructuring plans were made. They consisted of across-the-board measures (sometimes referred to as "linear" measures) and individual bank rehabilitation programs. The stated objectives of the across-the-board measures are asset and income rehabilitation. The implicit objective is to buy time for the preparation of restructuring programs for individual banks.

The first group of across-the-board measures focuses on asset rehabilitation. This program was designed to deal with three specific problems:

(1) the assumption of revaluation costs on selected foreign loans by the Federal Government budget;

(2) conversion of certain revolving NBY selected credits into long-term loans; and

(3) rescheduling of some Yugoslav debt to the USSR.

This set of measures is expected to reduce capital write-off by almost $2.5 billion. Appropriate legislation for this group of measures has already been passed and was effectively implemented in late May of 1991.

The second group of across-the-board measures focuses on income rehabilitation. It involves two measures, which both have the goal of increased interest income. The first increases the interest rate earned for required reserves held with the NBY. The second involves a temporary exchange of defaulted bad debt in exchange for interest bearing NBY 6-month revolving bills. The first measure is straightforward in its impact on commercial bank incomes and it does not require any further explanation.

The second measure, however, is more complicated. In addition to the NBY and commercial banks, it also involves the newly established Bank Restructuring and Deposit Insurance Agency (BRDIA) which will act as an important intermediary in the whole deal. The total amount for this program was set at 15.2 billion dinars or some $690 million at the going exchange rate. NBY 6-month bills in that amount were allocated to individual commercial banks in proportion to their total household deposits (both in domestic and in foreign currency). In exchange for the NBY-bills, commercial banks had to temporarily transfer some of their defaulted loans to the BRDIA and also agree that no further loans will be advanced to enterprises whose defaulted loans were placed in "deposit" with the BRDIA.

The net effect of that measure for commercial banks is threefold:

- an increase in their interest income,

- a required change in the bank credit management and credit worthiness assessment, and

- a discontinuation of the credit drain by non-performing insolvent enterprises.

The measure will also phase in the BRDIA which will monitor bank compliance with the requirements. Of course, there is also a net budgetary cost (interest on NBY bills) but it will be justified if the objectives of this measure are achieved.

While the Bank rehabilitation program sponsored by NBY and the Federal Government is a good stop-gap measure, it is unlikely to solve the solvency problems of banks in the medium run. This is because the insolvency of banks is linked to the losses of enterprises. As a result, a medium-term restructuring of bank assets and liabilities must be done in tandem with the restructuring of enterprises. Banks must be treated as part of the overall restructuring program, with Group I large banks and their associated large enterprises being given priority.

ANNEX K

ANNEX K: OWNERSHIP RESTRUCTURING IN HUNGARY

A. BACKGROUND

1. INTRODUCTION

Hungary recognized the deficiencies inherent in a centrally planned economy quite early. In 1968, they introduced the New Economic Mechanism (NEM) designed to promote greater worker productivity and efficiency in state-owned enterprises. Reforms in 1984-85 established enterprise councils in the majority of state-owned Hungarian enterprises and transferred some ownership rights to the councils. In spite of high expectations, this form of self-management did not improve economic efficiency and indeed the state never relinquished ultimate ownership to these councils.

The beginning of privatization in Hungary was the Law in Economic Association or Company Law of October 1988, which permitted state enterprises to "corporatize", that is to convert themselves into joint stock companies. The law also allowed for enterprises to issue new shares and to sell them to Hungarian or foreign buyers.

This initial privatization program allowed a large category of state-owned enterprises (so-called self-managed enterprises comprising about seventy percent of the total) to initiate and handle their own sale. This came to be known in Hungary as "spontaneous" privatization. By early 1990, about 150 state-owned enterprises had "spontaneously" privatized themselves.

The shortcomings of spontaneous privatization soon became recognized. Most significantly, the Law did not require that the sale of state assets be accomplished through open, competitive bidding and that the government obtain the highest price for its assets. Consequently, managers of enterprises were often accused of selling state property for bargain-basement prices, sometimes for questionable motives.

The Law on Protection of State assets of 1990 was designed to address some of the previous abuses of spontaneous privatization and to establish more rigorous oversight of the process. In March 1990, the State Property Agency (SPA) was created with a mandate both to limit undervaluation of assets in cases of privatization initiatives by the enterprise and to initiate privatization itself. In effect, the government awarded title of the majority of state assets (approximately 2,200 enterprises) to the SPA. This clarified the formerly troublesome issue of exactly what person or organizations in Hungary owned state property and therefor had the right to sell it.

The SPA, under the control of a Board of Directors appointed by the Prime Minister, was given the authority to either initiate or approve the privatization of any enterprise in its portfolio. In September 1990, the SPA has approved over 200 enterprise-initiated privatization proposals. Additionally, in September 1990, SPA launched its so-called First Privatization Program offering the sale of twenty large state enterprises to the private sector. That first wave is still in various stages of the sale process with varying estimates on when it will be totally completed. The SPA indicates, optimistically, that all twenty properties will be sold off by the end of March 1992.

Meanwhile, SPA embarked on a second wave of state initiated privatizations in December 1990. This mostly involved state-owned holding companies with some form of partial private ownership already in place. This second wave is effectively bogged down for lack of financing to carry out needed pre-sale restructuring actions. Early in 1991, SPA announced its intention of offering subsequent batches containing 20 or more companies every three or four months. Those subsequent waves have not materialized although there is a relatively small third program that is just getting started on an urgent basis. The "extra program" is aimed at finding buyers by the end of 1991 for certain enterprises that are relatively sound with good product lines but have been heavily reliant on now virtually collapsed Soviet and Eastern European markets.

Hungary hopes to privatize 500-600 firms by 1993. By 1996, it projects that 70 percent of state-owned assets will be partially or totally in private sector hands (these are exclusive of the small retail outlets that are owned by municipalities but still need SPA approval to sale). Given the centralized process and control of privatization in Hungary, with an SPA staff of only 120 people, the agenda appears to be an impossible task unless changes are made rapidly.

2. OBJECTIVES

Hungary's privatization objectives present a study of dichotomies while contrasting sharply in some respects with Poland and Czechoslovakia. Hungary is committed to a strong market economy and transfer of state-owned enterprises to private owners, whose interest will be to increase profits and share value. The government wants to reduce state ownership by at least 50 percent in the next five years. At the same time, they have imposed strong centralized decision making on the process with all ownership changes - even the smallest retail outlets - requiring SPA approval.

One SPA official described the First Privatization Program as both a "threat and a promise". It is a threat to current managers that enterprises will not be allowed to languish in state hands and a promise to the citizenry that the state would move resolutely by initiating its own multiphase program. Nonetheless, the government has been influenced by eminent Hungarian economists who argue that there is both a budgetary need and a fiduciary duty to the public to sell state-owned assets at the highest possible price. Such thinking stems from the fact that Hungary has the largest per capita convertible currency debt of any country in Eastern Europe ($21.7 billion at the end of 1990).

The current emphasis on maximizing sale proceeds through the competitive tender process is preceded by lengthy (and costly) pre-tender audits, evaluations, and sales strategies prepared by consulting firms or merchant bankers. This is already adding significant leadtime to the privatization process. Thus, the state appears to favor fast privatization but has a program that is all sales-based and centrally controlled. It has the earmarks of a more deliberative and lengthy privatization process than those being pursued in Poland and Czechoslovakia.

Effectively ignored in Hungary's overall sales-driven plan is the notion that the assets of the state really belong to the "whole people". Thus the results of privatization should be dispersed to the citizenry in some fair and equitable manner. Those who will mostly benefit from this sale program will be the privileged minority who accumulated funds under the old system.

In rejecting any type of non-sales based distribution of the state's wealth, such as being planned in Poland and Czechoslovakia, Hungary is convinced that they can sell most of their large companies either to foreigners, to the company's own managers, or to the country's emerging class of businessmen. Such thinking springs from the fact that their state-owned enterprises have been run more independently (over seventy are self-managed) and foreign investment and joint ventures were welcomed well before the Communists were overthrown. Such confidence can only be judged by the passage of time.

3. PRIVATIZATION PRINCIPLES

The main principles of Hungary's privatization are based on law and set forth by the State Property Agency as follows:

- the transfer of property rights has to be carried out by a market-oriented process and not through reprivatization or through redistribution of state property. The issue of land is being decided by Parliament. A law on land ownership is expected soon which would reprivatize the eighty percent of farm land in the state's custody. No reprivatization of property is envisioned. In lieu of reprivatization, the government proposes to provide partial compensation in the form of securities to previous owners, which can be used for buying new properties.

- the privatization process should conform to the characteristics of the market in terms of domestic and foreign demand and purchasing power. Where needed in certain cases, the state should intervene, e.g., liquidation of monopolies in strategic situations.

- applications of different privatization methods should promote a wide circle of investors.

- the execution of the government's privatization policy, the organization and monitoring of the process of privatization, and the selling of state-owned enterprises and companies are the tasks of the SPA.[1]

4. ENTERPRISE SEGMENTATION

The number of state enterprises to be privatized is close to 2,200, exclusive of small retail outlets, machine shops, small service organizations, and other similar enterprises. The book value of their assets exceeds $26 billion. Sixty-three percent of these enterprises were founded by ministries and thirty-seven percent by municipalities. Thirty-two percent of them are state administered and fifty-six percent are self-managed. The remaining enterprises are in company form and entirely owned by the state. Since the March 1990 creation of the SPA, over nine percent of all enterprises out of the total of 2,200 have been privatized fully or partially under the coordination and control of the SPA. As of late June, over 90 privatization proposals (enterprise initiated proposals) were pending SPA review and approval.

5. CHANNELS OF PRIVATIZATION

Hungary's privatization program is structured to provide four distinct channels for conversion of state property. These include:

a. SPA initiated privatization - also referred to as the "active program". This channel is aimed at privatizing from above. It was activated in September 1990, with SPA announcement of the so-called First Privatization Program. It consisted of twenty state enterprises, among them many of Hungary's most attractive companies. These included Hungarhotels, Danikus Hotel and Spa Company, Pannonia Hotel and Catering Company, the Ibusz travel agency, Richter Gedeon Chemicals, the Pannonplast Plastics Company, and the MEH Scrap Processing Trust.

The second wave of privatizations initiated by the SPA, announced in December 1990, includes holding companies with some degree of existing private ownership. These include the Bajatex Textile Company, Kobanya Textile Works, Budapest Leather Industrial Company, Csepel Works (a large industrial conglomerate), MOM Hungarian Optical Works (precision lenses and equipment), and 15 others. A third wave, the "Extra Program", is in the process of being formulated. It will include less than 20 medium size enterprises which produce reasonably marketable products but have been severely impacted by collapsing markets in the Soviet Union and elsewhere in Eastern Europe.

[1] See State Property Agency of Hungary (1991. p. 6).

SPA initiated the first and second program by issuing formal requests for proposals to consultants, merchant banks, and accounting/audit firms to act as "advisors" on a fee basis for the privatization of each company on the program. The primary job of the advisor is to prepare a detailed plan for privatizing a particular state company. The SPA then evaluates the plan and chooses one of three mechanisms or some combination thereof, to be used in privatizing the company:

- the public opening of shares through listing on a stock exchange (either the recently re-opened Budapest Stock Exchange or one or more Western exchanges);
- competitive tenders (either open or limited to preselected bidders); and
- employee share ownership plans (ESOP)

Discussions with the SPA and several public accounting firm officials indicate that neither stock flotations nor ESOPs have been used under the SPA-initiated program. There are only about ten stocks being traded on the Budapest Exchange. Parliament has twice failed to pass legislation that would finance an "Existence Fund" from which employees could obtain financial assistance to establish an ESOP.

Thus, the first wave relies on trade sales using open or limited competitive tenders. These transactions are being handled for SPA by investment banking firms on a success fee basis with support of third parties - generally Western public accounting firms - to perform independent evaluations of enterprise assets. In assessing bid prices, the SPA insists that they are seeking "fair market value" for their assets but other factors are considered as well. These included the buyer's strategic plan for the acquired company, the effect of the acquisition on employment, and the kind of management and marketing expertise, technology and financing that the owner agrees to provide.

Indications are that a number of the negotiations are going quite slowly because of the SPA's inherently deliberative style coupled with the inexperience of the SPA staff.

b. Investor - Initiated privatization - this form of privatization allows investors to initiate the privatization of a state-owned company by submitting a bid directly to the SPA to purchase the enterprise. No prior contact between the bidding parties and the state company is necessary. The SPA evaluates the bid, and if accepted, asks the management and workers to vote on the bid. However, even if the enterprise does not endorse the bid, the SPA has the authority to overrule the decision and permit an action similar to a Western-style "hostile takeover". This is open to both Hungarian and foreign investors but has only existed since January 1991.

The program envisages the appointment of an advisor firm to help guide SPA through the sales process. It also provides that the SPA can generate competition by seeking counter offers through public advertisement or direct contact. This program, according to the SPA, is directed at:

- retail trade and services under state ownership;
- public utilities;
- financial institutions;
- enterprises that dominate more than 40 percent of the domestic market;
- enterprises listed within the SPA-initiated active program; and

- state enterprises already transformed into economic associations.

In presentation of their offers, investors are required to furnish various documentation including:

- financing scheme (e.g., share purchase, buyout, etc.)
- proposed strategy for adding value to the enterprise (market extensions, technology transfer, management skills, etc.);
- services required by the investor (shares, rights to control, planned dividend strategy, etc.);
- intended strategy for the assimilation and cooperation with companies currently controlled by the investor;
- conditions of implementation or sale guarantees; and
- special conditions governing employee or management buy/out.

Depending on the size of the enterprise being sought by the investor, the SPA will employ a consulting firm to assist in:

- preparing company information material;
- obtaining counter offers;
- evaluating offers; and
- making the contract with the winning bidder.

The company information required to be prepared in accordance with international accounting standards includes: balance sheet and financial statement; a business plan; market/industry analysis; organizational and product analysis; and descriptions of manufacturing processes, capital equipment, purchasing, distribution channels, and customers. According to SPA instructions, this array of company data is to be collected within 30-60 days.[2]

c. Enterprise-Initiated Privatization - until 1990, this was the only privatization method authorized in Hungary. Prior to the passage of the Law on Protection of State Assets and creation of the SPA, over 150 state-owned enterprises "spontaneously" privatized themselves. Most notable was the Hungarian light bulb manufacturer, Tungstam, which sold 51 percent of its shares to General Electric in 1989.

The SPA has been put in place to ensure competitive bidding practices are followed and fair market value is obtained for state property. As a result, however, enterprise-initiated privatizations have slowed significantly. The SPA claims that 200 enterprises have been privatized using this channel since September 1990 and another 90 proposals are currently under review by the SPA.

[2] See State Property Agency of Hungary (1991a. p. 3-12).

Enterprise-initiated privatization procedures are much simplified compared to SPA or investor-initiated programs. They do not involve the use of consultants or other third parties. The SPA is hopeful that as the process is refined, it will be the most widely used channel for future privatization. It is expected that the force for maintaining momentum in enterprise initiated privatization would come from budgetary squeezes on individual firms. The State Finance Minister is committed to a balanced budget and this means less funding for industry. This should incentivize managers to seek more efficient operations or reorganizational opportunities available through privatization.

d. Pre-privatization - The fourth and final privatization approach used in Hungary is called "pre-privatization" and involves the sell-off of small state companies performing retail, catering, and consumer services. This program is governed by a separate law, "the Law on Privatization of State Enterprises Dealing With Retail Trade, Catering Trade and Consumer Services". There are over 10,000 of these enterprises to privatize. Unlike Poland and Czechoslovakia, which have delegated the auctioning off of these assets to regional offices or municipalities, the SPA maintains responsibility for disposing of these properties. Such centralization has caused the pre-privatization program to become clearly off track. To date, efforts have mainly focused on selling individual outlets of retail food store chains and large catering enterprises. However, only about 300 outlets have been auctioned off, (less than one percent of the total), and no specific strategy has surfaced to get the program back on track.

6. THE ROLE OF THE STATE PROPERTY AGENCY

Distinguishing Hungary's privatization program from those of Poland and Czechoslovakia is its centralized approach and the dominating role of the State Property Agency. It has less than 120 staff and plans are to keep its staffing at roughly that level.

SPA is not exercising any governance role over the state-owned assets under its control. According to the Law on the State Property Agency, the state property that belongs to the SPA can be managed by the SPA only on an exceptional and transitional basis. It must either be privatized soon or entrusted contractually for proper management to private property managing agencies (banks and other independent market organizations).[3]

SPA's mandate is to initiate privatizations of larger enterprises whose improved productivity and profitability are vital to the interests of the national economy. In the case of small and medium size companies, it is responsible for fostering an environment which encourages enterprises to initiate privatization themselves.

Meantime, the SPA is under increasing criticism as a bottleneck to ownership restructuring. The general feeling is that further legislative reform will be necessary to generate an acceptable privatization pace.

In the meantime, the SPA talks about "privatizing privatization" in order to cope with the task. SPA indicates that they intend to rely heavily on contracting out to merchant banks, consulting firms, and investment funds to accomplish certain tasks, while maintaining control over the overall process. A major issue is whether the SPA would be given an adequate budget for their contracting out or whether such costs as fees to merchant banks will be financed from sales proceeds. SPA is also pursuing a vigorous training program for its largely inexperienced staff. With help from such sponsor agencies as USAID, it is obtaining funds for installing management controls including an automated management information system.

[3] See State Property Agency of Hungary (1991. p.9).

7. FOREIGN INVESTMENT

Foreign ownership is not a sensitive issue in Hungary. Rather the country is committed to attracting needed Western capital. Its investment laws are the most favorable in Eastern Europe: 100 percent foreign ownership of companies is allowed; all profits may be freely repatriated; and no government investment permits are required. Further, tax incentives are designed to encourage foreign investments and joint ventures in industries believed to have export earning potential. If the foreign share of a joint venture equals at least 30 percent of total assets, a 60 percent tax holiday for up to five years is possible in certain sectors.

More than half of the foreign capital invested thus far in Eastern Europe has been made in Hungary. Over 5,000 joint ventures have been initiated with foreign participation. Expressed in U.S. dollars, the foreign capital investment exceeds $1 billion. The list of firms with investments in Hungary includes General Electric, Ford, General Motors, Siemens, Suzuki, Electrolux, Ericson (Sweden), and others.

8. PROCEEDS FROM SALES OF STATE-OWNED ASSETS

In Hungary, proceeds from privatization are to be used primarily to service the state debt, according to the State Property Agency. Also part of government policy are plans to transfer some limited number of shares in already transformed enterprises to local governments, as well as to the Social Security Fund, and to foundations and associations that benefit the public. It is also recognized that a portion of privatization proceeds will be needed to improve the administration and promotion of privatization itself.[4]

9. BANKING SYSTEM

While many conditions favor the attraction of foreign investment, the Hungarian banking system does not meet the needs of either foreign or indigenous investors. The problem appears to be more than banking reform. There is a need for training and education by banking experts. According to one source, half of the country's 40 banks have foreign participation but are simply unable to handle the surge of demands on their services. Entrepreneurs reportedly have had loan requests rejected mainly because banks do not have the resources to respond to an increasing number of loan applications. Banks also have rejected loan guarantees because of insufficient time, staff, and expertise to conduct feasibility studies.

The influx of foreign banks into Hungary has not noticeably eased the crisis. According to one report, foreign bankers have shown little interest in assisting most Hungarian entrepreneurs who are typically small investors offering banks little opportunity for substantive profit.

Hungary has submitted a plan to the U.S. State Department and Treasury Department seeking technical assistance and training for banking and other sectors. Meanwhile, the World Bank has made available over $2 billion in development funds for modernization of financial services as well as telecommunications, transportation, and energy conservation.

While current pressure on the banking system is great, as one official noted, it demonstrates that transformation and privatization of the nation's economy are moving ahead.

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[4] See State Property Agency of Hungary (1991. p.8).

10. RESTITUTION/COMPENSATION

Hungary's governing principle on transfer of property rights is that such transfer must be carried out by market-oriented privatization and not through reprivatization or through redistribution ("give away") of state property. The issue of land is an exception. Legislation to return the 80 percent of agricultural land in state hands to its original owners was recently vetoed by the constitutional court as being too narrow in scope.

Debate continues on whether owners of property confiscated after March 1949 should be compensated for their loss. Discussion has centered on a $70,000 maximum compensation in the form of shares in state-owned enterprises. Such securities could be cashed in to help pay for the acquisition of new property.

B. ACCOMPLISHMENTS TO DATE

Hungary has been moving towards private ownership for the past twenty years. Hungary's most singular accomplishment since the collapse of the Communist regime has been putting into place the legal and procedural framework necessary to complete privatize of its 2,200 state-owned enterprises.

Since March 1990, over seventy privatizations have been started with the assistance of SPA. Over 30 of those have been approved. Additionally, over 200 enterprise-initiated privatizations have been carried out since the inception of SPA and over 300 other small enterprises have been approved for privatization within the pre-privatization channel. Over 90 enterprise-initiated proposals are now in SPA's pipeline along with those projects in the first and second wave of SPA-initiated privatizations. SPA is projecting a completion date of first quarter 1992 for the first wave and estimates state proceeds from these sales between $385 and $615 million.

Hungary also had a recent success with the placement of $50 million in new shares issued by FOTEX, which had its start in the instant photo development business before expanding to crystal, eye glasses, and contact lens shops. This flotation, guided by Salomon Brothers, marked the first time since World War II that a private company in Eastern Europe has successfully raised funds on major equity markets. About half of the new 14.3 million shares registered on the Budapest Stock Exchange were sold to American buyers, primarily institutional buyers.

C. NEXT STEPS

In the active program, clearly the next steps are to (1) complete the sales under the first wave as soon as feasible, (2) address restructuring issues or other alternatives that will energize the apparently bogged down second wave program, and (3) pursue the third wave of enterprise privatizations in accordance with SPA's end-of-year completion target. For the investor-initiated and enterprise-initiated programs, SPA needs to train its staff and install the necessary management controls to improve "turnaround time" on these privatization proposals.

One encouraging new project being undertaken by the Minister of Industry is a study to determine the feasibility of establishing a turnaround/investment fund to help relatively small state-owned enterprises that otherwise face the prospect of bankruptcy. Seed money for this fund would be sought from private development funds like the Hungarian-American Enterprise Fund or counterparts in Western Europe and would be appropriated in conjunction with an approved privatization project.

While yet to be defined, another step that is desperately needed in Hungary is to find some means - perhaps legislative - to accelerate the privatization of small retail outlets as defined under the so-called pre-privatization program. The legislation covering this program was passed prior to the end of communism and, understandably, the government did not want to yield control of this program to communist-ruled municipalities. That is why SPA is responsible for execution of the pre-privatization program. With 10,000 or more small outlets to privatize, changes are needed to ensure privatization of these shops doesn't extend into the next century.

D. CONCLUSIONS

Hungary has long since taken its first steps toward an open market economy and private enterprise. Clearly, Hungary has had a substantial headstart over Poland and Czechoslovakia in privatization. Nonetheless, Poland, with its multi-tracks approach, may well catch Hungary in the near future, if it hadn't already. This reflects Hungary's deliberate, sales-oriented approach to privatization.

Hungary's main objective seems to be the best possible return from sale of its proceeds - without benefit, it should be emphasized, from major financial restructuring in advance of privatization. This objective stems from Hungary's heavy debt overhang and, it seems, the people are well reconciled to it. Possibly because its revolution was not fueled by labor unrest as in Poland, Hungary does not face the issue of popular ownership. Moreover, it is not so laden down with antiquated smoke-stack industries of questionable resale value as is Czechoslovakia. The Hungarian people seem to accept that approach more out of concern about preserving their jobs than the opportunity to invest in some unknown business enterprise. Furthermore, there are no imminent elections in Hungary to build pressure for a faster-paced privatization program.

That may all change with time. Hungary's heavily centralized privatization program may achieve fair market value in the sale of the enterprise; but unless the approval process is speeded up, the patient may not survive the course of treatment.

ANNEX L

ANNEX L: OWNERSHIP RESTRUCTURING IN CZECHOSLOVAKIA

A. BACKGROUND

1. INTRODUCTION

Privatization in Czechoslovakia is being undertaken in two steps. The first is the privatization of small firms, so-called "small privatization," covered by a law that became effective in November 1990. The second is the privatization of larger firms, "large privatization," for which enabling legislation was signed into law in February 1991.

The latter combines privatization initiatives by the enterprises themselves with state oversight and control. On their own accord or after mandate by their controlling agency ("founder"), enterprises prepare a privatization project which contains all relevant information about the enterprise and the proposed privatization (similar to a prospectus). This project package is submitted to the founding organ and, ultimately, to the Minister of Finance. After approval, the enterprise is transferred to the National Property Fund, which then proceeds with privatization by sale, distribution to the entire citizenry through a voucher scheme, or some combination of the two. An estimated 70 percent of the country's 4,800 state-owned enterprises will be required to come up with privatization plans.

Privatization of small enterprises--retail shops, restaurants, hotels, machine shops, service outlets, etc. -- are to take place mostly through auctions. The first such auction was held in January 1991. By the end of 1992, the government hopes to auction off 100,000 small-scale establishments (approximately half of the total), mostly through leaseholds.

2. OBJECTIVES

The genesis for economic reform and the transformation of state assets to private ownership in Czechoslovakia was the Civic Forum established in November 1989. It united Czechoslovak opposition groups such as Charta 77, the Helsinki Committee, the Circle of independent intellectuals, and many others. In its program published on November 26, 1989, the Civic Forum declared that Czechoslovak law must be in line with international agreements and treaties, and that the political system should be reformed into a democracy with democratic instruments and mechanisms in which all civilians may participate. Czechoslovakia should again have a respected status in Europe, should link up with European integration, and undertake profound reforms in the economic sphere. One month after the formation of the Civic Forum on December 19,1989, the new Czechoslovak government presented its program to the Federal Parliament entailing the transition to a free market economy and the opening up of the Czechoslovak economy to the world.[1]

Czechoslovakia's principle objective for privatization is to transfer the ownership of state enterprises to private hands as rapidly as feasible with a view toward improving enterprise productivity and generating economic growth.

In particular with regard to the beleaguered heavy engineering industries, Czechoslovakia will pursue "horizontal privatization" whereby enterprises will be transferred as rapidly as possible to a commercially administered (if not state-controlled) National Property Fund. In this way, the country hopes to achieve some degree of improved governance even before ultimate privatization of the enterprises. This strategy of "horizontal privatization" is aimed at achieving the earliest transformation of the most saleable of state assets while separating out and liquidating the most hopeless cases.

[1] See Klynveld Peat Marwick Goerdeler (1990. p. iii).

Another stated objective of the Czechoslovak government is attraction of foreign investment. Mr. Vladimir Dlouhy, the Federal Minister of the Economy, states: "Foreign investments are the building blocks of our future economic growth.... I welcome every foreign investment, and I am doing everything to persuade everyone that we should endorse foreign investments".[2]

Czechoslovakia is also committed to a course of dispersion of a large stake in the accumulated wealth of the state to the "whole people." The government intends to distribute 40 to 80 percent of the equity in 1,000 - 2,000 enterprises to the people by selling vouchers (at a nominal sum) to citizens over 18 years of age. These vouchers may be used to bid for shares in enterprises at auctions to be held beginning next year. Lists of firms to be sold through the voucher scheme are currently being drawn up.

Restitution or reprivatization of property confiscated unjustly after February 1948 is a cornerstone of the Czechoslovak privatization program. In some cases, property will be returned. In others, financial compensation can be given.

Finally, the Czechoslovak government is committed to dismantling its state-owned armaments industry, which between 1978 and 1988 was the world's eighth largest and the global leader in per-capita terms. The Federal Government has pledged to cut the output of weapons plants to seven percent of 1988 levels by 1993. Slovak politicians (the bulk of the industry is located in the Republic of Slovakia) are slowing down this process to stave off massive unemployment.

3. INSTITUTIONAL FRAMEWORK

There are three relevant governments in Czechoslovakia: the Federal Government; the Government of the Czech Republic in Prague; and the Government of the Slovak Republic in Bratislava. Under the new so-called Competency Law, the two constituent Republics will be responsible for their economic development while the Federal Government will create conditions for a single market. The Law extends significant economic powers to the Republics, particularly in the area of privatization. Each of the two Republics have privatization ministers, directly supported by very small staffs (5 - 15 persons). Each of the sectoral ministries in the Republic governments (i.e., industry, agriculture, foreign trade, etc.) which are the "founding organs" of the majority of state-owned enterprises will review and endorse privatization "projects" initiated by the enterprises themselves. The experience and capabilities of public officials involved in the privatization process in Czechoslovakia varies considerably.

Two other concerns are worthy of note. First operating procedures between the Federal Government and the Republic governments are still far from institutionalized. Secondly, the government--both at the Federal and Republic levels--does not seem to have the necessary resources and the capabilities to carry out privatization. One task is to marshall the requisite administrative machinery for both the collection and analysis of data necessary on the front end to put a privatization project together. A second task is to properly support the National Property Fund in all the actions necessary to transfer ownership from the fund to private ownership. There is a good core team in privatization, but it is not large enough, and financial assistance is needed to support augmentation of these core resources.

One does not see evidence in Czechoslovakia of the large presence of Western investment advisors, accounting firms, and consultants that are quite visible in Poland and Hungary. Bankers Trust, a British merchant bank, has been hired by the government to guide the overall privatization effort. However, some

[2] See Ondračkova (1991. p. 6).

indicate skepticism over the breadth and depth of their capabilities to perform this role effectively. Other Western experts will be hired, but they are not aboard yet in any sizable numbers.

In the Slovak Republic Government, an interesting example of an institution assisting with privatization is Interconsult, a state-owned enterprise. It has a staff of 116 people devoted to providing management consulting to Slovak enterprises (not heavy industry, however, since that sector comes under the Ministry of Economy). They perform feasibility studies, organizational studies, market projections and analysis, and also evaluations of enterprise net worth as part of the documentation needed for the privatization process. The Ministry of Industry founded Interconsult and is responsible for funding 50 percent of its budget. Interconsult is on its own for the rest. Interconsult was formerly an organizational entity of the Ministry of Industry and was known as the Institute of Economics and Management for Industry.

Since its entire staff is drawn from the bureaucracy of a former centrally planed economy, one wonders how effective such a group can be in helping enterprises position themselves for the transition to capitalism. They have plans for contracting out some of their work, but funding for such support is uncertain. Perhaps their eventual role will be that of an intermediary between Slovak enterprises and foreign investors (their charter does include "brokering cooperation between inland and foreign enterprises"); but this vague role seems to capture the character of a number of Czechoslovakian institutions at this point. Obviously, the "shakedown period" is only beginning. One can only speculate how long it will be before the privatization process is moving on a well-defined and productive track.

4. LEGAL FRAMEWORK

The legal framework for privatization has three main aspects: large enterprise privatization, small privatization, and property restitution or reprivatization. The three laws are discussed next.

a. LARGE PRIVATIZATION ACT

The Act implementing large privatization[3] provides that a transfer of assets will be based upon approval of a privatization project drawn up by the enterprise itself and approved by both the founding organ of the enterprise, and either the Federal Minister of Finance, where the founder is a Federal organ, or, the Republic government where the founder is a Republic organ.[4]

The privatization project of an enterprise will include:

a) definition of the assets to be privatized;

b) the manner in which the state acquired the assets;

c) description of that part of the assets unsuitable for entrepreneurial purposes (e.g. uncollectible debts, unusable fixed assets and stocks);

d) valuation of the assets to be privatized;

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[3]Act No. 92/1991 Concerning the Conditions for Transfer of State Assets to Other Persons, Effective February 26, 1991 (Large Privatization).

[4] See Central Europe Institute (1991. p. 6).

e) method of transfer of the assets to be privatized, inclusive of particulars for settling claims;

f) if a commercial company, its legal form;

g) if a joint stock company, the method to be used for dividing shares, the types of shares and their percentages, as well as information on whether and to what extent investment coupons (vouchers) will be used (shares equivalent to 3 percent of equity capital must be transferred to the restitution fund to meet future restitution claims);

h) in the event of sale, the type of sale as well as the established price and payment conditions;

i) specification of the assets to be privatized and the designated property funds to which those portions will be transferred. In the case of Federal property, transfer will be made to the Federal Fund of National Assets. In the case of Czech Republic property, transfer will be made to the Fund of National Assets of the Czech Republic. In the case of Slovak Republic property, the transfer will be made to the Fund of National Assets of the Slovak Republic;

j) method to be used for transferring industrial rights or rights to other intellectual property; and

k) timetable for implementation of the privatization project for the enterprise in question.

In addition to this information, the project will also include

- potential buyers of the property;
- the present and anticipated performance of the enterprise in the market; and
- the number and qualifications of the employees of the enterprise.[5]

As indicated above, upon approval of the enterprise for privatization, the assets of that enterprise and all rights thereto will be transferred to the appropriate Fund of National Assets. The assets of the funds may be put to use, in accordance with the approved privatization project, for privatization in the following ways:

a) to found a joint stock company or other commercial company;

b) to liquidate the assets through sale or lease of all or parts of an enterprise;

c) to transfer assets to municipalities;

d) to transfer assets to health or pension insurance funds.

In the case of the Federal Fund of National Assets, the Act outlines how the Fund is to be managed. It provides for the establishment of a nine member Presidium as its governing body, elected for five-year terms. No member of the Presidium may be an elected or appointed official of either the Federal government or the two Republican governments. In addition to privatizing assets under its management and ownership, the Fund may use those assets and profits generated therefrom to found joint-stock and other commercial

[5] See Central Europe Institute (1991).

companies, acquire stock, exercise stockholder rights, or otherwise acquire interests and share profits in commercial enterprises, as it deems appropriate.

The details of the organizational make-up of the Fund and of its activities are to be regulated by statute as approved by the Presidium of the Fund. At the same time, the Act does create two additional organs to participate in the management of the Fund. These are the Executive Committee and the Supervisory Council. The Executive Committee is responsible for carrying out the activities of the Fund within the framework of regulations and instructions emanating from the Presidium. The Committee consists of nine members, named by the Presidium for a term of five years, and are paid employees of the Fund. The Supervisory Council of the Fund is the "watchdog" for the state. It has the responsibility of alerting the appropriate organ, (the Government of the Czech and Slovak Federal Republic, the Federal Assembly or other organ) to any imperfections that it discovers.[6] The Council consists of five members, elected by the Federal Assembly for a term of five years.

Members of the Presidium, Committee, and Council and employees of the Fund may not undertake activities that would be in contradiction to the interests of the Fund. In particular, they may not be members of joint stock companies in whose activities the Fund has property interests. Members of the Presidium, Committee, and Council may not acquire assets of the Fund, except for those stocks that can be purchased for coupons (vouchers).

The Act also establishes provisions for investment coupons or vouchers to be issued to each Czechoslovak citizen over eighteen years of age giving the bearer the right to purchase shares in the equity of state-owned enterprises. The Act implies that the coupons will not be issued totally free of charge, stating that net income from the sale of coupons will be transferred to the fund of the Republic in which the acquirer has permanent residence.

b. SMALL-SCALE PRIVATIZATION.

The legislation enabling the transfer of small businesses under state ownership to Czechoslovak citizens was passed by the Czechoslovak Federal Assembly on October 25, 1990. Privatization of small firms covers retail shops, workshops, restaurants and other small businesses, not subject to restitution under reprivatization. The law is also meant to cover some plots of land or non-housing facilities under government ownership, as well as some branches of government enterprises that are capable of an independent existence. It does not apply to cooperative property. It provides for these businesses to be sold at auction to Czechoslovak legal and natural citizens.

Small privatization is to be carried out mainly by Republic and local government authorities. The law provides for the establishment of regional commissions by the respective Czech and Slovak Ministries for Management of State Property and Privatization. These commissions are to include representatives from local administrations, founders of the enterprise to be privatized, the "Town and Village Union," delegates from the Republic's national council, and representatives of pertinent trade unions.

The commissions are responsible for making up lists that describe the property or business and its obligations and claims. The property is then sold at public auction. The asking price for each property should be no less than 50 percent of residual book value of capital assets. In cases where depreciation is not taken into account, the price is 20 percent of the acquisition cost. Property with no declared owners or for which there are claims by previous owners applying for reprivatization are to be excluded from the list.

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[6] See Central Europe Institute (1991. p. 17).

All potential purchasers, including employees of the firm being auctioned, have equal bidding rights. Buyers must make final payment within 30 days of auction. An exception applies only to present users of properties. These users may purchase the service or business five days before the auction for the asking price.

The goal of small privatization is not to generate large sums of money for the state. Rather it is to privatize as many small businesses as quickly as possible. The law stipulates that 70 percent of auction proceeds are to be remanded to the government, while 30 percent goes to the local community.[7]

c. *LAW ON EXTRAJUDICIAL REHABILITATION.*

After long and protracted discussions, the Czechoslovak Federal parliament passed a restitution law in February 1991. The law provides that property unlawfully nationalized or confiscated between February 25, 1948 and January 1, 1990, will be reprivatized to citizens who are the initial owners of such property or to their rightful heirs. In such cases where the estate has undergone substantial change or no longer exists, financial compensation will be awarded. A six month statute of limitations has been placed on the filing of claims--to expire October 1, 1991. However, there is great concern that the settlement of compensation claims could extend for up to five years as multiple and conflicting claims for the same property are filed. Since there is little interest in the maintenance or development of property so long as its ownership remains in dispute, this could lead to a stagnation of the reform efforts. Also, the cost of paying compensation may overwhelm the courts and grind reform to a halt.[8]

5. PRIVATIZATION PROCESS

Project proposals are to be submitted to the founders for approval in two waves or stages, the first group by October 31, 1991, and the second by May 31, 1992. Currently, lists are being drafted within the various founding ministries to categorize enterprises and to determine in which stage they are to be processed. The categories are:

a) enterprises not to be privatized now (e.g., large infrastructure-type enterprises, such as utilities and telecommunications);

b) enterprises subject to the Restitution Law;

c) enterprises with the possibility of foreign participation;

d) enterprises to be liquidated; and

e) enterprises to be privatized by the voucher method.

An estimated 70 percent of the country's 4,800 state-owned enterprises will be required to come up with privatization plans. In the Slovak Republic alone, 500 to 1,000 enterprises are expected to be proposed for privatization in the first wave under either (c) or (e) above. At this point, it appears that the intention is to make enterprises in these two categories mutually exclusive.

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[7] See Central Europe Institute (1991).

[8] See Central Europe Institute (1991. p. 6-7).

With regard to how the vouchers are to be administered, no specific plan has been approved. According to one proposal, shares in specific companies will be auctioned to voucher holders in four or five lots throughout next year. Holders would use their vouchers to bid for shares. Shares which attract too few bids to be sold will be offered again in later auctions. As the auctions proceed, the scheme's advocates predict that demand for information about companies and the desire of voucher-holders to trade shares will encourage the development of a stock market, brokers, auditors, a business press, and all the other support mechanisms of Western capital markets.[9]

By some estimates, 30 to 60 percent of Czechoslovakia's enterprises are technically bankrupt. Many may actually fail once they are transferred to private ownership. As a result, individuals participating in the voucher scheme could find they own a chunk of nothing.[10] This could be one reason that Czechoslovak officials now are beginning to consider employing financial intermediaries, or mutual funds, after the approach being followed by Poland. The intermediary would be like a merchant bank, funds manager and management consulting company all wrapped into one and would serve to mitigate risk for the individual investor. Individuals would invest in the mutual fund rather than in the enterprise directly, because the fund manager would have superior knowledge of the enterprises plus provide portfolio management.

Another variant discussed would allow the voucher holder the flexibility of either buying shares in the mutual fund or investing in the enterprise directly. How many of these mutual funds would be established is uncertain. An overall plan for the voucher scheme is due to be announced sometime this fall.

6. FOREIGN INVESTMENT

Also clouding the future is the uncertainty surrounding the attraction of badly needed foreign capital. Czechoslovakia has been assessed as the best risk of any Eastern European country for Western investors attributable to its diversified industrial potential, low level of debt, and attractive exchange rate. Out of 1,000 joint ventures with Western participation, however, the great majority are still very small. To date, the only significant exceptions are Volkswagen's commitment to acquire a 70 percent stake ($780 million) in Skoda, Czechoslovakia's leading auto producer, and the joint venture between Glaverbel, a Belgian firm, and SKLO Union, a Czech glass producer, in which the former has agreed to invest $45 million. This reluctance on the part of foreign investors stems from a combination of factors--lack of tax incentives (a new tax law will not take effect until 1993), uncertainties with respect to the effects of the restitution law, the poor banking infrastructure, concerns over profit repatriation, and ill-equipped, inefficient plants woefully in need of large modernization investments.

7. RELATED ISSUES

a. *ARMS INDUSTRY*

A privatization issue unique to Czechoslovakia is the planned dismantling of its military arms industry. Some 80,000 jobs, the bulk in restive Slovakia, depend on arms production. As indicated earlier, the Federal government has pledged to cut the output of weapons plants to seven percent of 1988 levels by 1993. While Slovak officials have been slowing the cutback and a prospective tank sale to Syria has evoked international interest, arms sales to the Soviet Union dropped 40 percent last year and will drop further this year. In all, military production this year has dropped to less than one quarter of 1988 levels. Some agreements have

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[9] See *Economist* (1991. p. 83-84).

[10] See *Ecomonist* (1991).

been reached for production of non-military equipment. ZTS Martin, the tank producer, has orders from a German firm to manufacture earthmoving equipment and is working under license to an Italian manufacturer to produce tractor engines and other machinery. Nevertheless, unemployment in Slovakia is running four percentage points ahead of the rest of the country, and the gap threatens to widen further.

b. HEAVY INDUSTRY

An equally serious problem is the huge industrial plants, ranging from heavy engineering, to mining, steel and outdated nuclear technology, which carry enormous pollution liabilities. This makes them virtually impossible to sell despite the government's sweeping plans. Whereas light industrial concerns may prove attractive to Western partners, the heavy industry enterprises which were directed to the Eastern market and organized in big conglomerates, must undergo major restructuring if not liquidation.[11]

At the same time, there is an industrial tradition which Poland and Hungary cannot match. One consultant noted, "They have a very skilled workforce but lack the management expertise to utilize it."
According to the Industry Minister, Mr. Jan Vrba, production has fallen 40 percent in the first three months of 1991, with some industries faring for worse.[12] According to forecasts by Morgan Stanley, this year should see the bottom of the trough for the Czechoslovak economy. Industrial output, which fell by an estimated four percent last year, is forecast to drop another ten percent this year and three percent in 1992. Recovery thereafter will depend to a large extent on how quickly the Czechs can develop a private and more service-sector economy to replace the heavy industrial base.[13]

B. ACCOMPLISHMENTS TO DATE AND NEXT STEPS

Measurable progress to date lies for the most part in the small privatization program. This began in January with the first of hundreds of auctions to sell off between 170,000 and 200,000 retail and service outlets, hotels, restaurants, and manufacturing shops. No final numbers are available on how many enterprises have been privatized, but officials are confident the task will be essentially completed by the end of 1992. Most of the privatizations are in the form of leaseholds rather than sale.

A timetable has been established for the submission of lists of candidate large enterprises to be privatized in the first and second waves. Project submissions are due at the founding organs for each wave by the end of October and next May, respectively.

A plan for implementing the voucher scheme should be completed this autumn.

C. CONCLUSION

In terms of the overall approach, Czechoslovakia's privatization program, like that of Poland, has a good deal to commend it. The Federal government has overall responsibility for policy guidance and direction. The authority for execution lies predominantly within the two Republics.

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[11] See Brazier (1991. p. 26).

[12] See Brazier (1991).

[13] See Brazier (1991).

The program is designed to "commercialize" immediately those enterprises approved for privatization by shifting their assets to National Asset Funds. The ultimate privatization plan, already approved by the government, will be executed under the stewardship of an independent, albeit quasi-governmental, body. Thus enterprises will undergo rapid, yet orderly, transformation and improved governance even as the final privatization action is being carried out. At the same time, Czechoslovakia recognizes that the assets of state-owned enterprises really belongs to all the citizens (the "whole people") and is preparing to give shares in many enterprises to the people.

Also worthy of note is Czechoslovakia's apparent plan to use proceeds from sale of state-owned enterprises to finance other privatization projects and thus provide further stimulus to the economy. The National Assets Fund is almost like a "non-profit" organization - paying privatization expenses rather than raising revenues. The Law on Large-Scale Privatization does not make any specific provision for how the proceeds from privatization are to be used except to stipulate that claims for compensation under the restitution law may be settled from assets of the Fund.

The Law further states that assets of the Fund may be used for the fulfillment of obligations of enterprises scheduled for privatization. With the need to address the ills of the heavy smoke-stack industries in Czechoslovakia coupled with the need to convert the military arms industry, to non-defence production, it is not difficult to visualize that the great bulk of proceeds from privatization will need to be plowed bulk into enterprises restructuring projects - financial mostly but also physical.

The Government will try to sell off assets without pre-privatization restructuring, but a lot of enterprises are heavily debt-laden and probably will need some form of financial restructuring to make these enterprises saleable. Company indebtedness is estimated at about $1.5 billion in Czechoslovakia. The solutions, according to the Czech Republic Industry Minister, Jan Vrba, include pooling some of the debt within a state-owned agency or using privatization proceeds to pay off borrowings.[14]

It is not clear whether the state plans to retain a partial equity position in enterprises it privatizes. What is known is that three percent of equity capital in joint stock companies must be transferred to the restitution fund to meet future restitution claims. What seems clear is that both the federal government and the two republic governments are fully committed to privatization in its most ultimate sense.

Having said that, apart from the small privatization program, Czechoslovakia's privatization program is just beginning. While the basic enabling legal framework is in place, Czechoslovakia finds itself in June 1991 still trying to decide which enterprises to sell to the people. They are behind both Poland and Hungary, and speed is essential. With elections coming up next year and given a formidable Socialist movement that is particularly active in Slovakia (where there is great unrest over rising unemployment), the government must show progress and benefits from a free market economy very quickly.

It is not very clear how that can be achieved. Czechoslovakia has attracted little foreign investment. They badly need foreign investors, so that investor-driven privatization can get out ahead of government-initiated privatization. The latter probably won't start showing results for at least a year, and perhaps longer.

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[14] See Brazier (1991).

ANNEX M

ANNEX M: OWNERSHIP RESTRUCTURING IN POLAND

A. BACKGROUND

1. INTRODUCTION

With the goal of creating an efficient market economy, the government of Poland in 1989 embarked upon a major program to transform state assets into private ownership. Rapid privatization of state assets is the goal. Central to this program is the "Privatization Law for State-Owned Enterprises" adopted in July 1990, and the establishment in September 1990 of the Ministry of Ownership Changes (MoOC).

In recognition of the various types of enterprises to be privatized, potential sources of private ownership, and the limited availability of private capital and management skills in Poland, the government has chosen a "multi-track" approach to privatization. The privatization program utilizes both the conventional methods of enterprise sale and an innovative plan to involve the broad participation of Polish citizens in private ownership through free issuance of "investment coupons" convertible to shares in the various companies being created out of formerly state-owned enterprises.

Poland is committed to a privatization program aimed at transforming its ownership structure to one resembling that of Western Europe within the next five years. Approximately half of the state-owned assets are to be privatized within the first three years.[1]

2. OBJECTIVES OF PRIVATIZATION

Poland's stated objectives for their privatization program are as follows:

- move the economy from a centrally-planned economy to a competitive market system, encouraging the creation of a profitable private sector;
- improve the performance of enterprises through a more efficient use of labor, capital, and management skills;
- prevent possible distortions of privatization (for example, the sale of state assets to foreign investors at unduly low prices);
- reduce the size of the public sector and the burden on the public budget and administration;
- generate funds from the sale of enterprises or their shares;
- ensure a wide diffusion of ownership of privatized assets;
- provide an effective system of corporate governance; and
- commence the program of exchanging the external debt of the country into equity in privatized enterprises.

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[1] Much of the following is based on discussions with staff of the World Bank in Washington D.C. familiar with developments in Poland.

3. PRESENT FORMS OF OWNERSHIP

There are currently four forms of ownership in Poland:

- Treasury property comprises state-owned enterprises and state budgetary entities, such as schools and hospitals;
- municipal property, with municipally-owned enterprises and municipal budgetary entities;
- property owned by cooperatives and state farms; and
- private or semi-private property (joint ventures between state-owned enterprises and private foreign or local partners).

There are approximately 9,000 state-owned enterprises in the "productive" sectors, approximately 4,500 of which are controlled by the 49 "Wojewoda" (regional governments) in the country. The government intends to privatize the majority of state-owned enterprises over the next five years. The state budgetary entities are to remain state property for the foreseeable future.

The municipalities predominantly control local wholesale and retail trade enterprises (for which the founding organ is typically the mayor or the municipal council). There are roughly 100,000 municipal enterprises. These are being privatized at the present time mostly through leaseholds to individuals or small enterprises. Municipal budgetary entities (e.g. water treatment facilities; sewage plants) are expected to be privatized only to a very limited extend.

Cooperatives represent a major part of the economy and contribute almost 20 percent to GNP. There are about 13,000 cooperatives. They carry out a wide range of economic activities including agricultural and industrial production, wholesale and retail trade, religious, artistic and social activities, all of which are controlled by different laws. The privatization of cooperatives remains "spontaneous" at this time and is not adequately regulated or legislated.

The private sector has traditionally been strong in agriculture (over 70 percent of arable land is privately owned), small artisan manufacturing, and retail trade and has experienced a significant growth since adoption of the new policies. By the end of 1990, approximately 23,000 private corporations were in operation as well as 1,400 joint-venture companies.

4. DELEGATION OF DECISION-MAKING UNDER STATE OWNERSHIP

Under the classical central planning system, the functions of enterprises were largely determined by the central plan. The founding organ (the relevant ministry or Wojewoda) maintained formal oversight of the enterprise.

Beginning in 1981, enterprises were granted increasing operational and financial autonomy. While enterprises continued to be owned by the state, the responsibilities entrusted to the enterprises were exercised principally by the workers. This was typically accomplished through an assembly of the workers (similar to an annual shareholders meeting) and the Workers Council. The Council was the governing body responsible for all decisions relating to the activities of the enterprise including the right to appoint management of the enterprise or veto the government's choice.

In some cases, the Council has effectively controlled the enterprise. In others, the managers of the enterprise have acted with considerable independence of the Council and the state. Consequently, various ownership rights (use of property, financial returns, and disposal of property, among others) have been held jointly, but in a confused and shifting way, among managers, the workers, and the state. Such confusion has created serious problems. Managers have tried to appropriate the income and strip the assets of the enterprise. Also, Workers Councils have pressured managers to raise wages significantly.

5. PRIVATIZATION STRATEGY FOR STATE-OWNED ENTERprises

The privatization strategy adopted by the government employs a multi-track approach. It has separate privatization paths for the various categories of enterprises, often with simultaneous use of different techniques of privatization within a category. Enterprises are categorized by:

(a) their size (large enterprises may require a diversified ownership structure. Small and medium enterprises can be sold in whole or in part to a single acquirer);

(b) economic and financial viability (viable companies would then be categorized as to their immediate salability or need for prior restructuring); and

(c) ownership (state-owned enterprises, under federally controlled or under the jurisdiction of local authorities).

The Privatization Law provides for two main alternative routes to privatization:

(a) "commercialization" or "corporatization" of state-owned enterprises to be followed by transfer of their capital to private owners;

(b) the liquidation route, with the dissolution of an enterprise and the privatization of its assets.

Generally, state-owned enterprises which are in viable financial and structural condition are prepared for eventual privatization through transformation to a state-owned corporation (either a joint stock or limited liability company) under the governance of the Commercial Code. Enterprises which are "non-viable" are liquidated, in other words, they are closed down with their remaining assets being sold or leased.

a. *PRIVATIZATION THROUGH COMMERCIALIZATION*

The first step of the privatization process is commercialization, the transformation of a state-owned enterprise into a joint stock or limited liability company owned by the state. This step is intended to:

(a) provide a clear decision-making and control structure;

(b) adjust the legal status of state-owned enterprises to the requirements of potential foreign corporate partners;

(c) create pressure for market-oriented restructuring; and

(d) prepare the enterprise for privatization.

Commercialization is a vital step towards privatization and is considered a priority in the privatization process by the government. It effectively concentrates the ownership rights of the enterprise in a corporate

Board of Directors appointed by the state. It introduces the concept of sound corporate governance to enterprises.

The Privatization Law provides that commercialization be initiated by either the enterprise or its founding organ (in agreement with the management and Workers Council) or be imposed from above by the Prime Minister, upon a motion of the MoOC. Immediately after commercialization, a Supervisory Council (Board of Directors) is appointed for the new joint stock company. Two-thirds of the members are appointed by the MoOC and one-third by the old Workers Council. Once the equity has been totally or partly transferred to private shareholders, a new council is appointed, with the directors selected by the shareholders meeting as per the Code of Commerce. Training of candidates for the Supervisory Councils has commenced. The MoOC is expecting to train about 40 to 60 candidates per month.

After commercialization, enterprises are exempt from paying the obligatory "dividend" tax and 20 percent of the excess wage tax ("popiwek"). The dividend tax is a tax levied on a portion of the capital of the enterprise and is based on the current refinancing rate of the National Bank of Poland. The excess wage tax is levied on the portion of the wage increase which is above the allowable wage increases.

With a view to an effective implementation of the program, the MoOC, while emphasizing the principle of voluntary commercialization, has also established a number of criteria for enterprise selection. These include:

(a) the size of the enterprise in terms of annual turnover, number of employees, and absence of a monopolistic position;

(b) historical and anticipated financial and operational performance;

(c) transparent legal situation, especially with respect to ownership of the land and buildings, and the absence of an artificial multi-plant structure;

(d) interest of potential domestic and foreign investors in the state-owned enterprise; and

(e) equality of interpersonal relations within the enterprise among management, workers, and unions.

Thus, in addition to changing the legal status of an enterprise, the government wants commercialization to be the catalyst for the restructuring program.

b. THE NEXT STEP TO FULL PRIVATIZATION

Following commercialization, the next step (according to the Law) is privatization through one of two alternative methods:

(a) individual or "customized" privatization; or

(b) mass privatization.

(1) INDIVIDUAL PRIVATIZATION

Individual Privatization, along traditional lines of public offerings or direct (trade) sales to domestic and foreign investors, is considered the appropriate approach for the larger and more viable enterprises. This includes the top 500 enterprises in the country.

In the case of public offerings, each enterprise will be evaluated independently by Western merchant banks and public accounting firms. Potential investors will be provided with a prospectus specifying asset valuation, historical financial data, and an outline of the enterprise's plan for the future. Operational experience gained in five pilot privatizations, (discussed below) is expected to provide significant insight into the process.

According to the Privatization Law, employees of state-owned enterprises are entitled to purchase up to 20 percent of the total amount of shares at a discount of 50 percent of the offering price, subject to certain limitations.

The MoOC also may sell large enterprises directly to large domestic or foreign investors. This can be accomplished either through (a) a private sale to a single or several investors, or (b) a full scale domestic or international tender.

The privatization of small and medium-sized enterprises is similar to the larger enterprises. First they will be transformed into a state-owned corporation. Next the shares of this corporation will be offered to employees (employee buy-outs), investors (typically private individuals or groups of individuals), or domestic and foreign firms. The process may be initiated either by the enterprise concerned, a potential buyer with an offer to purchase a block of shares, the founding organ, or the MoOC. The acquisition of shares can be facilitated by special credit programs, such as bank credit made available by the National Bank of Poland.

For privatization of small and medium-sized enterprises, the government is carrying out a more decentralized approach. In the first half of 1991, eleven regional offices of the MoOC are being established. At the initial stage of decentralization, the regional offices have responsibility only for preparation of the enterprises for privatization, not the authority to approve the transformation. Overall control of the privatization process will, for now, be maintained by the MoOC.[2]

(2) MASS PRIVATIZATION

In view of the lack of adequate domestic capital resources and the relatively short time period allocated for the privatization process, the government has adopted "mass privatization" as a method to accelerate the process as well as spread the ownership of the state's wealth to all citizens. The mass privatization scheme envisages privatization by the following methods:

(a) offering shares to employees on preferential terms;

(b) free distribution of vouchers to Polish citizens redeemable for shares in National Wealth Management Funds (similar to Western mutual funds) which would serve as a financial intermediary and hold shares in privatized firms; and

(c) allocation of shares to pension funds and other financial intermediaries.

Actual mass privatization will be undertaken beginning in early 1992. Meanwhile, substantial preparations are being made. These include:

- screening large and medium-sized enterprises to select those appropriate for mass privatization (400 enterprises have now been targeted and the names announced);

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[2] See Bureau of National Affairs, Inc. (1991. p. 15).

- drawing up the details of the voucher distribution and Management Fund operations;
- verifying potential Polish institutional investors such as commercial banks, insurance agencies, and pension funds;
- assessing the macro-economic consequences of mass privatization; and
- conducting a public information program.

(3) THE VOUCHER SCHEME

The Privatization Law specifies the free distribution of vouchers to all Polish citizens. These vouchers will be exchangeable for shares in newly created financial intermediates, established in the form of so-called "National Wealth Management Funds". These funds run by experienced Western investment managers will act as investment bank, holding company, mutual fund, venture capital manager, auditor, and consulting firm, all rolled into one. Initially, there will be five such funds (perhaps as many as twenty eventually) and the exchange of vouchers for shares in these funds will be evenly allocated among the five. The latest information indicates that about 60 percent of the equity of the 400 now-identified enterprises will be offered to these funds. Fund managers will determine which enterprises they wish to invest in using the vouchers as "investment capital" to bid their interests. There is no intention to create Funds that have specialized or industry-related portfolios. Fund managers, like typical mutual fund managers in the United States, will be free to invest as they see fit across the 400 enterprise spectrum.

The remaining equity in state-owned enterprises will vary depending on the individual situation. However, the government has announced that 10 percent will be set aside for employees to invest in those firms in which they work and the government will retain up to 30 percent. This retention of ownership is aimed at creating investor confidence in the privatized enterprise rather than any motivation toward retaining control of the firm. In fact, the plan calls for fund managers to manage many of the stakes retained by government. The remaining shares in privatized enterprises will be distributed among state pension funds and other institutional investors, and private domestic or foreign investors on a case-by-case basis.

It is hoped that Fund managers, with their pay pegged to the performance of their funds, will be active owners and the primary agents for restructuring many of Poland's industries. They will be able to buy and sell shares, organize joint ventures with foreign investors, and put companies into bankruptcy. After a period yet to be decided, individual share holders will be able to trade their shares in the Funds, thus imposing market discipline and incentives for the Funds themselves. Meanwhile, individuals will be free to buy shares of individual companies with cash.

A key issue in the implementation of these Funds is the question of how to capitalize them initially to provide for their start-up operation. The government is in process of mobilizing domestic sources of capital (e.q., private capital, banks, insurance agencies, pension funds, and trade unions) and is encouraging foreign investors to participate as well.

c. LIQUIDATION

A state-owned enterprise may also be privatized through liquidation by its founding organ, on its own initiative or at the initiative of the workers council, with the approval of the MoOC. Three forms of privatization are permitted by the Privatization Law:

(a) sale of all or part of the assets of the liquidated enterprise to a new company, joint stock company or limited liability company created (for example) by the employees of the former state-owned enterprise;

(b) contribution of assets to such a company; and

(c) lease of assets.

Leasing has proven to be the most popular method of privatization through liquidation and is most frequently applied in the case of smaller firms. The liquidated enterprise is typically leased to the employees of the enterprise upon the employees contributing a minimum share capital equivalent of at least 20 percent of the capital of the former enterprise. The Commercial Code, moreover, requires employees to pay in only 25 percent of their contribution to the equity of a privatized enterprise. In this sense, leasing may be considered equivalent to an installment sale. The employees are initially liable for only a portion of the share capital of the new corporation, and retain the flexibility to pay in the remainder over a specified period.

6. REGIONAL PRIVATIZATION

Of Poland's 9,000 state-owned enterprises in the productive sectors, approximately 4,500 are controlled by the 49 regional governments (Wojewoda) as founding organs. These comprise many of the small and medium-sized enterprises in the country. Additionally at the municipal level, there are approximately 100,000 largely wholesale and retail trade enterprises where the founding organ is typically the mayor or municipal council. Not considered here are the nearly 13,000 cooperatives, which fall outside the Privatization Law and for which no clear legal framework has yet been provided. There have been a significant number of spontaneous or largely unregulated privatizations of these cooperatives. The specific issues relating to cooperatives are addressed below.

While not much privatization effort has been exerted yet at the regional or "wojewoda" level, significant progress has been achieved in the area of "small privatization," that is, the privatization of the approximately 100,000 small and medium-sized retail and wholesale shops. An estimated 90 percent of these outlets have already been privatized. Typically, the employees establish a new corporation and then take over the assets of the outlet through a lease. In the majority of cases, employees possess preemptive rights and preferential terms for leasing the outlet. In some areas there were instances of auctions being held that resulted in uneconomically high rent rates being extracted from the new "owners." The government has taken steps to control that practice.

7. FOREIGN INVESTMENT

Foreign investment, typically through joint ventures, has been an active (if not particularly noteworthy) route to privatization. Nevertheless the role of foreign investment is envisioned as a key element of the overall privatization effort, and this has led to enactment of a revised Foreign Investment Law within the past month. The new law eliminates the minimum investment amount ($50,000) and the requirement that foreign equity participation above 10 percent be approved by the Foreign Investment Agency. It also provides a number of tax and other incentives including:

(a) repatriation of 100 percent of after-tax profits and capital invested;

(b) guaranteed compensation of all losses as a result of expropriation or a similar event;

(c) customs exemption for in-kind contributions to capital; and

(d) accelerated depreciation.

The inflow of foreign investment this far has not been of a size or character that would contribute significantly to Polish economic growth. Although there have been over 3,500 joint ventures approved, the average foreign equity investment has been relatively small (US $140,000). Last year, a modest $100 million was invested from abroad in Poland compared to one billion dollars in Hungary. However, government officials are optimistic that investment will improve greatly. Within the past few weeks, General Motors, for example, entered into serious negotiations with the major Polish car producer on a joint venture.

8. PROCEEDS FROM PRIVATIZATION

The Polish government has made it clear that their first priority is balancing the budget and reversing their pattern of heavy borrowing. Thus, it can be anticipated that proceeds from the sale of state-owned enterprises will be applied toward achieving a balanced state budget, if not used to retire existing debt. Observers point out, however, that earlier this year major government creditors agreed to forgive half of Poland's $33 billion official debt, and President Bush announced even more generous terms by offering 70 percent forgiveness during President Walensa's visit to Washington in March of this year. Such relief should free funds for rebuilding the domestic economy and creating opportunities for Western investors.[3]

9. LEGAL FRAMEWORK

The fundamental legislation underlying the privatization program is the "Privatization Law for State-Owned Enterprises" (1990). Other key legislation includes

(a) the "Anti-Monopoly Act" (1990), which establishes on independent Anti-Monopoly Office and provides for the break-up of large monopolistic SOEs and cooperatives prior to privatization;

(b) the "Law of Economics of State-Owned Enterprises" (1981), as amended in 1987, 1989, and 1990, and its implementing decrees, which governs state-owned enterprises;

(c) the "Commercial Code" (1934), as amended on various occasions and which governs the joint stock and limited liability companies which cannot immediately be privatized; and

(d) the "Bankruptcy Law" (1987), which governs the bankruptcy and subsequent liquidation of joint stock and limited liability companies.

As discussed above, vital legislation was just passed in the form of the "Foreign Investment Law", which replaces the "Law on Joint Ventures" (1988). It allows 100 percent repatriation of profits and provides the basis for a coherent, simplified, Western-style tax system.

To support the process of enterprise reform and privatization, the government introduced or modified a number of laws with a view to providing the legislative basis for a free market economy. The "Law on Financial Management of State Enterprises" (1989) reinforces financial discipline on enterprises by imposing budget constraints and making compulsory "dividend" payments and providing for a periodic revaluation of assets. The "State Enterprise Law" was amended in 1990, and allows the founding organ, in collaboration

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[3] See Moskaluk (1991. p. 38).

with the Ministry of Finance, to force a non-performing enterprise into bankruptcy, suppress its workers council management system, and turn the enterprise over to a "Recovery Commission."

The liquidation amendment to the Privatization Law is being used extensively to privatize SOEs. In addition, amendments were made to the "Law of Bankruptcy" by which all enterprises, state-owned and otherwise, are equally subject to normal bankruptcy procedures.

The government also amended the "Land Law" in December 1990 to address the issue of the ownership of land and other assets by both domestic and foreign investors. The changes provide that

(a) foreigners are permitted to acquire privately-held land;

(b) foreigners are permitted access to state-owned land through the mechanism of a perpetual (99 year) lease; and

(c) Polish citizens will be permitted to own multiple real estate assets and will be allowed unlimited and unconditional access to agricultural land.

Possibly no other legislative package has received such debate and aroused so much emotion in Poland as has the draft reprivatization act approved on June 4th by the Council of Ministers. The draft stipulates that claims may be submitted by persons (or their heirs) whose property was taken over by the state during the time frame 1944-1960 contrary to the law then in force, and by those who have not received legal compensation due them from the state. Compensation will be in the form of capital bonds enabling owners to purchase shares in enterprises being privatized and guarantees them priority in purchasing shares in firms they formerly owned. The actual return of property will be an additional form of compensation and will be limited to special cases, for example, if the property now belonging to the state or local government is not being used. A separate Act will address the problem of claims against state farms from former landowners. The current proposal is for former landowners to receive from 50 to 100 hectares of substitute farmland. Claimants must agree to farm the land as a condition for approval.

10. INSTITUTIONAL FRAMEWORK

The key institutions influencing the privatization process are the Ministry of Ownership Change (MoOC) and the "founding organ." The latter is a ministry at the Federal level, a regional authority (Wojewoda), or a municipal authority (Qminas). Under the Privatization Law, the privatization of state-owned enterprises is entirely under the direction of the MoOC. The principal functions of the MoOC are to initiate, monitor, and control the process of privatizing state-owned enterprises. It is also called upon to provide legal and operational assistance in the privatization of enterprises at the regional or municipal level. The founding organs are responsible for initiating enterprise privatization and the preparation of an enterprise for privatization (in terms of breaking up large enterprises and liquidating non-viable enterprises). Supporting institutions include the Foreign Investment Agency, which becomes involved when foreign participation is envisaged, and the Anti-Monopoly Commission.

The financial sector requires further development for the success of the privatization program. Specialized financial institutions, the Industrial Development Agency (IDA) and the Polish Development Bank (PDB), have been established to assist in financing the overall privatization and restructuring effort. Both have been established as joint stock companies with an appointed Board to ensure autonomy from the government. The IDA will assist enterprises seeking restructuring assistance, and the PDB will provide medium and long-term financing for restructuring through a network of financial intermediaries.

The development of a transparent and efficient capital market is a key element of the institutional framework required for success of the program. The Warsaw Stock Exchange, opened in the spring of 1991 and patterned after the Lyon France exchange, is still very much in its start-up phase with only five stocks being traded currently. A newspaper account shows that on June 22, 1991 the Exchange traded a high of 15,170 shares.

The regulation and supervision of the capital market is contained in the securities law, the "Bill on Public Trading and Trust Funds," which was approved by Parliament in March 1991, and is implemented by the Securities and Exchange Commission (SEC). The SEC, to be established as a new state administrative entity, will be responsible for the public trading in securities. It will also provide educational and information services for investors and develop a comprehensive educational/training program for stockbrokers and SEC employees.

An important element in the mass privatization effort is the emergence and development of the National Wealth Management Funds. These intermediary institutions will hold the vouchers of the Polish citizens. The government will provide substantial support for establishment of these funds.

The training of Board members, managers and capital market participants is crucial to the privatization effort. The MoOC has embarked on the recruitment and training of directors to the supervisory boards of the commercialized enterprises. The objective is to train 1,500 to 2,000 directors by the end of 1991. The MoOC has also established a training institute, the School of Finance and Management, which offers training programs at various levels for directors, managers, and stockbrokers.

11. SPECIFIC SECTORAL DEVELOPMENTS

Although the privatization program is generally aimed at all sectors of the economy, the bulk of the effort, to date, has been directed at the manufacturing sector. This focus is understandable given the concentration of state-owned enterprises in the manufacturing sector. However, there exist a large number of SOEs and public enterprises in other sectors which require a more "customized" program of privatization given the specific characteristics and problems of each sector. The government is currently preparing specific sectoral studies with a view toward undertaking "cluster" privatizations. These would involve preparing a group of small or medium-sized enterprises for privatization within individual sectors. Key considerations in various sectors are highlighted in the following paragraphs.

a. *AGRICULTURE*

The government intends that the privatization of this sector be done selectively. The current draft legislation on the privatization of state farms, mentioned earlier, seeks the transfer of state-owned farm assets to joint stock companies. The commercialization of the 2,200 farms, representing 25 percent of Poland's agricultural land, will commence formally after passage of the law. Some of the activities required are to:

(a) inventory land, buildings, and equipment on these farms;

(b) assess their financial prospects; and

(c) determine which state-owned farms should be divided and sold to private farmers, which should be leased, and which should remain state property.

b. BANKING.

The financial sector is principally comprised of the central bank, the National Bank of Poland (NBP), six specialized banks, nine commercial banks, a small development bank, and some 60 newly established private banks. The nine commercial banks were established in January 1989 out of the NBP and are now charged with all corporate lending activities. Recently, the news media quoted President Walensa as saying that the head of NBP has until January of 1992 to privatize at least five of the nine commercial banks or face being terminated.[4] Under current plans for their privatization, foreign banks are to be offered a 20 percent share in each bank while the state retains a 30 percent "golden share". Between 40 and 50 percent of the equity is to be offered to domestic investors.

c. CULTURE

The state-owned enterprises under the jurisdiction of the Ministry of Culture are in the areas of retail and wholesale publishing, musical instrument manufacture, printing, music, and entertainment. Different methods of privatization will be used for each sub-sector, although most are characterized by breaking up large monopolistic enterprises into smaller, more viable entities prior to privatizing. The printing and musical instrument manufacturing enterprises are being privatized through the liquidation method.

d. ENERGY/MINING

This sector is dominated by coal which in 1990 accounted for 95 percent of primary energy production. The sector employed over 500,000 people in 1990 and accounted for 10 percent of GDP. The coal mining sector now consists of 68 independent coal mines and the Hard Coal Agency, but is expected to be restructured into 10 to 15 independent joint stock companies. The Hard Coal Agency plays the role of a "transitional" holding company for those mines which are to be closed down.

Other key issues in the sector include (a) shortage of qualified management, (b) shortage of domestic capital, and (c) the need for a comprehensive legal and regulatory framework. A new Energy Law is being formulated. Numerous loans, mostly from the World Bank, are helping to modernize this sector. These include: a \$250 million Energy Resource Development Project to help increase the domestic production of natural gas; a \$100 million loan for an Industrial Environment Project to assist in restructuring efforts of major industrial polluters including the coal sector; and a \$150 million loan for a Heat Supply Restructuring and Conservation Project aimed at increasing energy efficiency and reducing coal-related pollution through modernization of district heating networks and through air pollution abatement investments.[5]

e. FOREIGN TRADE

There are presently 72 foreign trade enterprises of which 26 are SOEs and 46 are joint stock or limited liability companies. The SOEs account for 20 percent of total exports. Approximately 30 percent of these SOEs were spontaneously privatized prior to the formal implementation of the present privatization program. The Ministry of Foreign Economic Relations is the founding organ for all state-owned foreign trade enterprises. The privatization program for this sector, which has the approval of the MoOC, must deal with the following issues:

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[4] See Bobinski (1991).

[5] See World Bank (1991. p. 11).

(a) the need to restructure and break up a number of enterprises;

(b) the high valuations that will be attributable to some SOEs owing to their vast marketing and information networks; and

(c) the capital accumulated by the majority of the enterprises which may be utilized in other areas of the economy.

Coopers and Lybrand is assisting the government in carrying out the privatization of foreign trade associations.

f. HOUSING CONSTRUCTION

There are four major "agents" in the housing sector: cooperatives, municipalities, enterprises, and private households. Cooperative housing accounts for about 50 percent of new housing. State housing comprises two types, enterprises and municipality housing, and accounts for about 30 percent of new housing. The housing sector has been deteriorating steadily over recent years. The number of households exceeds the number of dwellings by 18 percent, the highest in eastern Europe. The average time to complete new housing is between 2 and 5 years, compared to one year in Western Europe.

A number of other problems confront this sector:

- the institutional and legal framework are under substantial overhaul;
- a shortage of developed land for housing exists attributable to: uncertainty over land tenure given lack of a land privatization law; an over restrictive regulatory environment; and lack of financial resources for infrastructure development;
- the monopolistic and capital intensive construction industry has high fixed costs and low productivity;
- need to broaden sources of funding (away from government subsidies);
- need to restructure housing cooperatives, both "ownership" cooperatives and "tenant" cooperatives; and
- a defined program is needed to address the completion of the unfinished stock of housing, the sale of the majority of the public rental housing, and the introduction of new techniques for managing remaining public housing.

g. TRANSPORTATION

The enterprises here are very diversified each with specific problems. The principal sub-sectors are: railway; air transport including airports; road transport (trucking and passenger services); and water shipping services (including ports). Apart from the road transport and airline sub-sectors, privatization in the other sub-sectors is expected to be largely confined to commercialization and restructuring. LOT, the national airline company, is seeking a private buyer for 40 percent of its equity.

B. ACHIEVEMENTS TO DATE

Until the enactment of the Privatization Law, privatization had been limited to "spontaneous" privatizations of state-owned enterprises, largely at the initiative of the employees and management of the enterprises.

Since then, however, the government has achieved substantial progress in the process of privatization, as delineated below.

1. ESTABLISHMENT OF THE MOOC AND DEVELOPMENT OF A PRIVATIZATION STRATEGY

The MoOC was established with assistance from bilateral sources (USAID, British Know-How Fund, France) and advice from the World Bank. It is the principal department of the government with the mandate to initiate, control, and monitor the privatization effort. Although staffing is still inadequate (120 local staff and 40 foreign advisors, at last count) and significant technical assistance continues to be needed, the MoOC has successfully developed a privatization strategy and has achieved considerable progress in its actual implementation.

2. COMMERCIALIZATION OF ENTERPRISES

A major effort has been made to initiate the voluntary commercialization of state-owned enterprises. As of the first quarter of 1991, 107 enterprises have been commercialized, of which 57 are slated for individual privatization. The government has plans to incorporate up to 1,000 enterprises this year to provide a "pipeline" for privatization.

3. PRIVATIZATIONS

In addition to the spontaneous privatizations of Universal, a foreign trade enterprise, and BIG Bank, a state-owned commercial bank, the individual privatizations of eight large enterprises have been accomplished. Five were done by public offering, two by trade sales to foreign investors, and one through an employee leveraged buy-out. The pilot privatization through public offering of five enterprises was completed in January 1991. These included: Exbud Kielce (construction); Krosno Glass Works; Prochnik (a Lodz-based garment producer); Tonsil (audio equipment producer); and the Silesian Cable Factory. While the initial closing date had to be extended--only Exbud was fully subscribed by the original closing date--ultimately, all five offerings were oversubscribed by between 7 and 20 percent. The premium of the issue price over the book value of the enterprises ranged between 70 and 150 percent. The offerings were principally targeted at the domestic market, although some foreign participation was permitted.

In addition, two enterprises, Fampa and Polam Pila, were sold to foreign companies, with 80 percent of Fampa being acquired by Beloit of Germany and 51 percent of Polam Pila by Phillips of the Netherlands. Another enterprise, Zaklady, was purchased by the employees in a leveraged buy-out, with equity being fully paid up and the debt to be paid off over five years. Total estimated proceeds from these privatizations were approximately $43 million.[6]

Preparations are currently underway for a second wave of public offerings. This wave will initially involve 5 to 6 medium-sized enterprises.

The government has also made substantial progress in the development and preparation of the mass privatization program. In the last week of June 1991, the Polish government announced their plan for their mass privatization program which will be implemented beginning early next year. The plan, drafted with the help of the British merchant bank, S. G. Warburg & Co., calls for the establishment of National Wealth Management Funds which, collectively, will hold 60 percent of the shares in 400 state enterprises. The

[6] See Economist Intelligence Unit (1991. p. 9).

nature of these funds will be as previously described--a mutual fund but with fund management being exercised more on the order of a holding company.

In addition to the public offerings and trade sales, 143 small and medium state-owned enterprises have been privatized through the liquidation route. Of these, 48 were privatized through the sale of assets and 95 through either leasing or installment sale. In addition, Orbus, the large hotel and travel conglomerate in Poland, is currently being examined for physical restructuring in anticipation of offering its severable entities for sale in the near future.

The government has expectations of picking up the pace of the individual trade sales to domestic and foreign investors in the second half of 1991, and anticipates privatizing 50 - 60 small and medium enterprises per month through asset sales (liquidations). These plans are exclusive of restitution privatizations which will begin as soon as the new legislation is passed and signed by the President.

4. OTHER

The government has made additional progress in terms of enacting the new Foreign Investment Law, opening the stock exchange this spring, and establishing the new Securities and Exchange Commission. Also, an Anti-Monopoly Commission has been established to regulate against monopolistic activity.

As indicated earlier, a training institute has been established, and training commenced for future supervisory board members, stockbrokers, and Polish consultants in the area of finance and management. A separate institute has also been established to assist in regional privatization.

C. NEXT STEPS

The government intends to achieve the following during the remainder of 1991 and early into 1992:

- Complete the legal framework in support of privatization: amend, revise, or replace the Law on the Economics of State-Owned Enterprises, the Commercial Code, the Cooperatives Law, and the Bankruptcy Law.

- Prepare enabling legislation for the mass privatization program and privatization of cooperatives. Enact the legislation on the law on reprivatization and compensation, and legislation for land ownership.

- Accelerate the commercialization of an additional 1,000 enterprises at the national level and 1,700 enterprises at the regional or local level to achieve an adequate privatization pipeline.

- From among the largest 500 state enterprises, press for completion of 40 - 60 privatizations by the end of the year via public offerings (15), sale to domestic investors (15-20) and foreign sales (5-10).

- Complete through the liquidation route the sales of assets of 50 - 60 enterprises per month.

- Carry out conversions of national debt into equity of privatized enterprises.

- Based on the new finalized plan, make all preparations to launch the mass privatization program in early 1992.

- Finalize and commence implementation of sectoral privatization programs (i.e., commercial banks, insurance agencies, cooperatives, foreign trade companies).
- Further support and accelerate regional privatization.
- Substantially increase the focus of the Foreign Investment Agency towards promotion.
- Establish an inter-ministerial task force to monitor the overall progress of privatization/restructuring and take active measures to ensure that it continues rapidly and efficiently. This includes a re-definition of the organizational structure and clarification of the respective roles of the two principal ministries in the privatization process--MoOC and the Ministry of Industry, especially with respect to marginal cases of SOEs requiring restructuring.

D. CONCLUSIONS

One gets the sense that the Polish government has gone beyond the conceptual development and is beginning to implement an intensive privatization program. Nearly eighty percent, by most estimates, of their legal and institutional framework for implementing privatization of state-owned enterprises is in place and the required balance seems to have the focused attention of an action driven government. Through commercialization, some measure of improved governance is being achieved pending ultimate shift in ownership.

Recognizing the need to carry out the process rapidly, Poland is combining individual enterprise privatization--sales to either domestic or foreign investors--with a plan for mass privatization, which is designed for dispersion of a large amount of the nation's wealth among all its citizens. Thus, a stake in the accumulated wealth of the nation remains with "all the people."

Further, Poland will use the proceeds from its sales of state-owned assets to help retire the nation's debt. In this way, capital is re-circulated within the economy to fund new investment. A record of debt retirement, in general, will help strengthen Poland's credit rating, which is vital considering the new loans it expects from the World Bank alone. World Bank loans are expected to total $2.5 billion over a three year period beginning in 1990.

Foreign investors have not been beating a path to Poland--with the possible exception of Germany. Many of Poland's large enterprises need extensive restructuring before they can be transferred to the private sector. Meanwhile, privatization is not universally popular. According to one recent poll in the Politika Magazine, 71.3 percent of the workers prefer either continued state ownership or worker ownership.

Poland is beginning to receive a massive amount of assistance from the World Bank, International Monetary Fund, the Paris Club, the European Bank for Reconstruction and Development, USAID, the British Know-How Fund, and others. Considerable amounts are being directed toward restructuring numerous large enterprises, if not whole industries and economic sectors. This massive assistance coupled with the legions of merchant bankers, accountants, and management consultants who are on the ground in Poland--not to mention the obvious resolve of the Polish government--all leaves one with the distinct impression that privatization has a solid chance of succeeding.

ANNEX N

ANNEX N: TRANSFER OF OWNERSHIP TO INSTITUTIONS

A. INTRODUCTION

Transferring ownership of socially-owned enterprises to institutions in a relatively new concept. It emerged as a result of research on how to privatize the Eastern European economies quickly, while introducing at the same time effective corporate governance and making the privatization fair and equitable from socio-political point of view.

The key element is the introduction of one additional set of institutions standing between the enterprises that are to be privatized and individuals.[1] Each institution would hold a portfolio of shares in many enterprises but with a large interest in each of them. The institutions should be capable of monitoring the managers of enterprises effectively, in more or less the same way as in the Western economies. By introducing a new set of institutions, effective corporate governance of privatized enterprises will be secured.

This new set of institutions can be introduced in a short period of time, so that privatization can proceed rapidly. Some of those institutions already exist (commercial banks, pension funds), and the others can be created quickly with the help of foreign expertise. Distributing the shares of those institutions equally to all members of the society would in turn guarantee fair and equitable privatization of social capital. The following analyzes some of the major alternatives that have been proposed.

B. ALTERNATIVE PROPOSALS

1. THE HINDS PROPOSAL

In his comprehensive study, M. Hinds proposes to transfer ownership to financial intermediaries.[2] He does not specify a model of privatization for any particular Eastern European country. He is of the opinion that successful privatization requires a flexible approach tailored to the specific conditions of every country.

M. Hinds advocates two phases. In the initial phase, privatization would be carried out by the transfer of ownership without payment. In the subsequent phase, it would be through the sale of shales. He suggests that in the first phase the government should distribute about 80 percent of shares of enterprises to institutional investors (pension funds, holding companies, mutual funds, and similar institutions), and in turn distribute their shares to the population. Alternatively the shares of enterprises could be distributed to the population directly, but he does not favor this idea. Such a dispersed private ownership would present problems similar to that of self-management. Without a controlling shareholder, effective corporate governance will not be possible, and the management would not be controlled by the owners.[3]

In the second phase, the government would sell the remaining 20 percent of shares. Since the purchaser of such a block of shares would largely control the enterprise, the shares could be sold at a premium.

The proposal is primarily intended to strengthen corporate governance of newly privatized enterprises. By distributing 80 percent of equity to the institutional investors, these few large owners are likely to exercise effective control over the managers of enterprises. In the alternative of distributing of equity directly to the

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[1] See Blanchard (1990).

[2] See Hinds (1990).

[3] See Hinds (1990).

population, the controlling shareholder would be the government prior to the sale of the remaining 20 percent of equity. By selling the government's block of shares to a stable core owner (using the French concept), the government would secure effective corporate governance of enterprises only after their full privatization.

2. THE DORNBUSCH PROPOSAL

Dornbusch has developed a privatization scheme completely based on free distribution of shares to institutions. Its main elements are:[4]

1. All socially-owned capital would be allocated to a few funds (holding companies or mutual funds).

2. All citizens would receive shares in each of these funds. A portion of social capital would also be used for financing pension funds and the government budget.

3. The shares of the funds would be transferable and freely tradable but with some time lag to avoid instant liquidation and sale at low prices.

4. The funds are required to distribute earnings and pay taxes.

5. The funds are to be liquidated or broken down into a number of smaller funds over some period of time.

Even though Dornbusch did not discuss his proposal in detail, the advantages are clear. Privatization of Eastern European economies needs to be done fast and in such a way that it will enable enterprises to be well managed. It can be done only if social capital is transferred free of charge to institutional owners. To make the privatization fair and equitable from the social point of view, Dornbusch suggests giving away the shares of mutual funds to the population.

Another feature of his proposal is to use privatization as an instrument of financing pension funds and the state budget. It obviously implies capitalization of pension funds and the creation of state holding company for managing its stock of capital.

3. THE FISHER AND GELB PROPOSAL

Fisher and Gelb also favor rapid privatization via transfer of ownership to institutions.[5] They emphasize the "corporatization" of Eastern European enterprises, i.e. a change in the status of the firms so that they become a joint-stock or other form of corporation. The crux of the privatization problem is large socially-owned enterprises. By comparison, small firms and shops can be easily privatized.

If privatization is to be rapid and if effective corporate governance is to be introduced, Fisher and Gelb argue that Eastern European countries have no alternative. They argue that state holding companies should play an important role in ownership reform. Their proposal is as follows. The state should create a number of holding companies or unit trusts. The shares of socially-owned enterprises would be distributed among them, so that they become the dominant or controlling shareholders. There should be a sufficient number of

[4] See Dornbusch (1990).

[5] See Fisher and Gelb (1990).

new institutions to ensure competition among them. The state might retain a block of shares in each enterprise which can be later sold or freely distributed to the citizens.

In this way, rapid privatization and effective corporate governance would be ensured quickly. In the longer run, the authors suggest privatization of holding companies or their conversion into pension funds. If the state decides to privatize holding companies by distributing their shares to citizens, it will in fact transform them into mutual funds. The state can also decide to convert holding companies into pension funds, what can be done by transferring to them the appropriate pension liabilities.[6]

4. THE BLANCHARD PROPOSAL

An interesting privatization proposal was suggested by O. Blanchard, et al.[7] It is part of a comprehensive program for market reform of Eastern European economies. The authors define privatization as a process of establishing a clear system of ownership claims. Privatization is urgent and needs to be done quickly. After privatization, restructuring of enterprises would take some more time. Though badly needed, improvements in efficiency will be gradual. They argue that privatization in Eastern Europe should take place mostly through free distribution rather than through the sale of ownership claims. They stress that large shareholders with a controlling interest are necessary for efficient management of enterprises.

Thus they conclude that the privatization process must quickly put in place large shareholders capable of managing the enterprises. Accordingly they propose the creation of holding companies whose own shares would be traded in the stock market. These companies would have the mandate to restructure and divest firms in their portfolio over some period of time.

The role of holding companies would be twofold. Firstly, holding companies would be designed as a transitory device. Their role would merely be to restructure, divest, and than sell all the enterprises in their portfolio. In this regard, holding companies can be thought of as privatization agencies. Secondly, holding companies would be designed as a part of the newly emerging ownership structure, i.e. one among a number of newly created institutions in a market financial system. If instead holding companies are to be permanent owners of enterprises, they would play the role of financial intermediaries. They would be similar to mutual funds.

The Blanchard proposal favors privatization via holding companies defined as privatization agencies rather than mutual funds. Their main objective is the fast creation of an ownership structure that should lead to effective control of enterprises in Eastern European economies. Since the holding companies are to become the sole owners, there is no doubt that they would have the power to control the enterprises. The authors are aware of the problem of monitoring the managers of holding companies, but they argue that the government and the stock market would be able to do this.

Their privatization scheme has the following features:

1. The government should create a number of holding companies, each of them holding all the shares and having full control over a portfolio of enterprise. Each holding company should hold a roughly similar portfolio of enterprises.

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[6] See Fisher and Gelb (1990).

[7] See Blanchard (1990).

2. Shares in the holding companies should be distributed equally to all citizens. They are to be ordinary shares and able to be traded in the stock market (perhaps offer some phase-in period).

3. The holding companies should divest themselves of their holdings over a certain period of time. The explicit objective of holding companies would be to restructure and then sell enterprises. The proceeds of sales should be returned to their shareholders as special dividends. Holding companies would be prevented from lather borrowing or issuing additional equity.

4. Dividends are to be paid in the form of cash or in the form of shares in conventional mutual funds. A cash distribution implies the need for a fast creation of a system of financial intermediaries capable of collecting the dispersed savings of the population. The distribution of shares in mutual funds seems to be more appropriate for countries with an undeveloped system of financial intermediaries.

The authors emphasize that the scheme should apply only to the privatization of large socially-owned enterprise. It is not applicable to the privatization of housing and small socially-owned firms and shops. Privatization of those sectors should be approached in a different way.

The authors do not favor giving workers a special right to shares in their own enterprises since this would be unfair from a social point of view. If such a right is given, workers should not be given a controlling interest in the enterprises, and the shares held by workers should be freely tradeable in the stock market.

The authors do not oppose giving banks and pension funds an important role in the privatization process. In their proposal, banks participate in privatization by lending to potential buyers, while pension funds are to play an important role in later phases of the privatization process. If the banks are to play a more important role in the privatization process from the very beginning, a German or Japanese type of ownership structure would tend to emerge in newly privatized socialist economies. In particular such a system would not work well in the countries where the banking system is in its infancy.

The authors believe that pension funds and similar institutional investors could play an important role in privatizing Eastern European economies. Those large institutions are the major owners of shares in almost all Western economies (for example, in the UK) institutional investors account for 67 percent of total share holdings.[8] But, the authors believe that such institutional investors would emerge in due time, after holding companies begin to divest and distribute the proceeds of sales through dividends.

The authors strongly believe that developing a stock market is essential for the success of the privatization process in Eastern Europe. But at the same time, they underline that it would be naive to expect that a stock market with dispersed ownership could be effective in valuing individual firms and providing control of managers. At least this would not occur in the foreseeable future.

5. THE LIPTON AND SACHS PROPOSAL

Lipton and Sachs have also proposed a privatization scheme based on transfer of property rights to institutions. It differs from the previous one in the sense that it transfers property rights to the institutions on a permanent basis. Lipton and Sachs advocate privatization via distribution of social property to new financial institutions (pension funds, banks, investment trusts, mutual funds, etc.).[9]

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[8] See Blancherd (1990).

[9] See Lipton and Sachs (1990).

This privatization program is based on two main objectives. The first objective is to establish effective ownership and corporate governance. They emphasize that simple transfer of ownership to the private sector is not of crucial importance in designing the privatization program. It is naive to expect that the stock market in Eastern Europe would ensure effective management of enterprises in the near future. The second objective is to define clear property rights in a short period of time.

Lipton and Sachs argue that the governance of enterprises should be removed from the workers councils as quickly as possible and placed under the control of new owners. They do not see how self-management of enterprises and the market economy can be reconciled. They do believe, however, in the need to compensate partially workers for the transfer of control from workers councils to private owners.

Their proposal distinguishes between large, medium, and small scale privatization, but it concentrates on the problem of privatizing large-scale enterprises. They are of the opinion that the privatization of small and medium-sized enterprises would not pose serious problems, since it can be achieved in a variety of ways (worker-management buyouts, contracting-out, leasing, etc). Accordingly, there is no need to prepare a nation-wide privatization program to handle small socially-owned enterprises. The privatization of these enterprises should be mostly the responsibility of local government.

The privatization program prepared by Lipton and Sachs consists of three main steps. The first step is to nationalize self-managed enterprises. This scheme presents a case study for Poland. Self-management in Poland was introduced about one decade ago, and by now it is a well established mechanism of managing enterprises in that country. Thus the self-management of enterprises has to be eliminated and enterprises converted into government-owned joint-stock companies. In this way large enterprises would be transformed into the corporate form.

The next privatization step is to create a structure of ownership which would enable effective control over the enterprises by new owners. This is to be achieved by rapid and free transfer of social property to various institutitons, workers, and the government. The authors propose the following:

- 15% of shares would be given at low price or for free to workers and managers of enterprises,
- 20% of shares would be given free of charge to pension funds, to capitalize a new private pension system,
- 10% of shares would be given free of charge to the banking and insurance sector and used to capitalize existing commercial banks and insurance companies,
- 20% of shares would be given to mutual funds, whose shares in turn would be distributed free of charge to the population, and
- 35% of shares in the partially privatized enterprises would be retained by the government, to be sold in the third privatization step.

The intention of the third privatization step would be to sell gradually the remaining 35 percent of shares as a block to a stable core investor, i.e. to domestic, foreign, or mixed investor groups, who will then take a key role in management of the enterprise.

At the beginning of the privatization process, socially-owned and self-managed enterprises are to be transformed into corporate form. It would be the first step in improving their management. The next step is to introduce institutional owners or financial intermediaries (banks, pension funds, mutual funds) as the main force in monitoring and controlling the behavior of enterprises. Financial intermediaries are much better owners than the state or workers councils, but they are not entrepreneurial in their nature. To remove this deficiency of ownership structure and introduce an owner with more of an entrepreneurial motivation, the third step would be for the government to sell the remaining 35 percent of shares to a stable core investor. This solution is intended to ensure that the stable core would become the primary investor group and as such would take a dominant role in supervising corporate management of enterprises.

6. THE HANKE PROPOSAL

The final proposal is that made by S. Hanke.[10] Its essential feature is to transfer social capital without payment to newly created private pension funds. The intention of the proposal is to "capitalize" pension funds. If the amount of social capital exceeds what is required to fully capitalize pension funds, the remaining part could be transferred to the banking system and used to capitalize commercial banks.

This proposal seams to have two main intentions. The first would be to privatize quickly socially-owned enterprises. Second is to resolve one extremely serious financial problem of the government, i.e. to rehabilitate and financially strengthen pension the system of the country.

This proposal seems to have weakness. Almost all enterprises of the country would be governed and controlled by pension funds. The entrepreneurial nature of pension funds is opened to rather serious doubts.

C. CONCLUSIONS

The privatization proposals differ from each other but have important similarities. They differ mostly in the details of what kind of financial intermediaries or institutions are to be created or used in privatizing socially-owned capital. To some extent they also differ in respect to the role of the state in the privatization process.

Another difference is that the proposal made by Blanchard et. al. emphasis the need for restructuring the newly privatized enterprises. In the others, there is an implicit assumption that the new owners would have a strong interest in restructuring the enterprises in their portfolio.

All proposals are similar in respect to their primary objectives. All of them have the clear objective to privatize social capital quickly but in a way that will enable rapid introduction of effective corporate governance. They are searching for a better owner of social capital, who will have a strong motivation to govern the enterprises. All of them also believe that privatization should be fair and equitable from a socio-political point of view.

All of these proposals contain only a brief outline of a privatization program. They are not elaborated to the point where they could be implemented immediately. If any one of them is to be implemented, a lot of additional work needs to be done.

[10] See Hanke (1990) and Hanke (1991).

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ANNEX II

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OWNERSHIP RESTRUCTURINMG
IN
YUGOSLAVIA

Robert E. Anderson
Coopers & Lybrand
United States Agency for International Development

11 December 1991

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WHY HAVE CAPITALIST ECONOMIES BEEN MORE SUCCESSFUL?

- COMPETITIVE MARKETS
- PROFIT MOTIVE
- RESULT:
  - GREATER EFFICIENCY
  - LOWER COSTS
  - INNOVATION AND GROWTH
  - HIGHER INCOMES

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TYPES OF ECONOMIC SYSTEMS

	TYPE OF OWNERSHIP		
	STATE	**SOCIAL**	**PRIVATE**
CENTRALLY PLANNED	Soviet Union		war economies
COMPETITIVE MARKET	theoretical option	Yugoslavia	USA Germany Japan

CRITERIA FOR JUDGING OPTIONS

- IMPROVED CORPORATE GOVERNANCE?
- FAIR AND EQUITABLE?
- FAST?
- OTHER IMPACTS
  - INVESTMENT
  - SAVING
  - INFLATION

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WHAT IS THE BEST SYSTEM OF CORPORATE GOVERNANCE?

OWNERS

↓

BOARD
OF
DIRECTORS

↓

MANAGERS

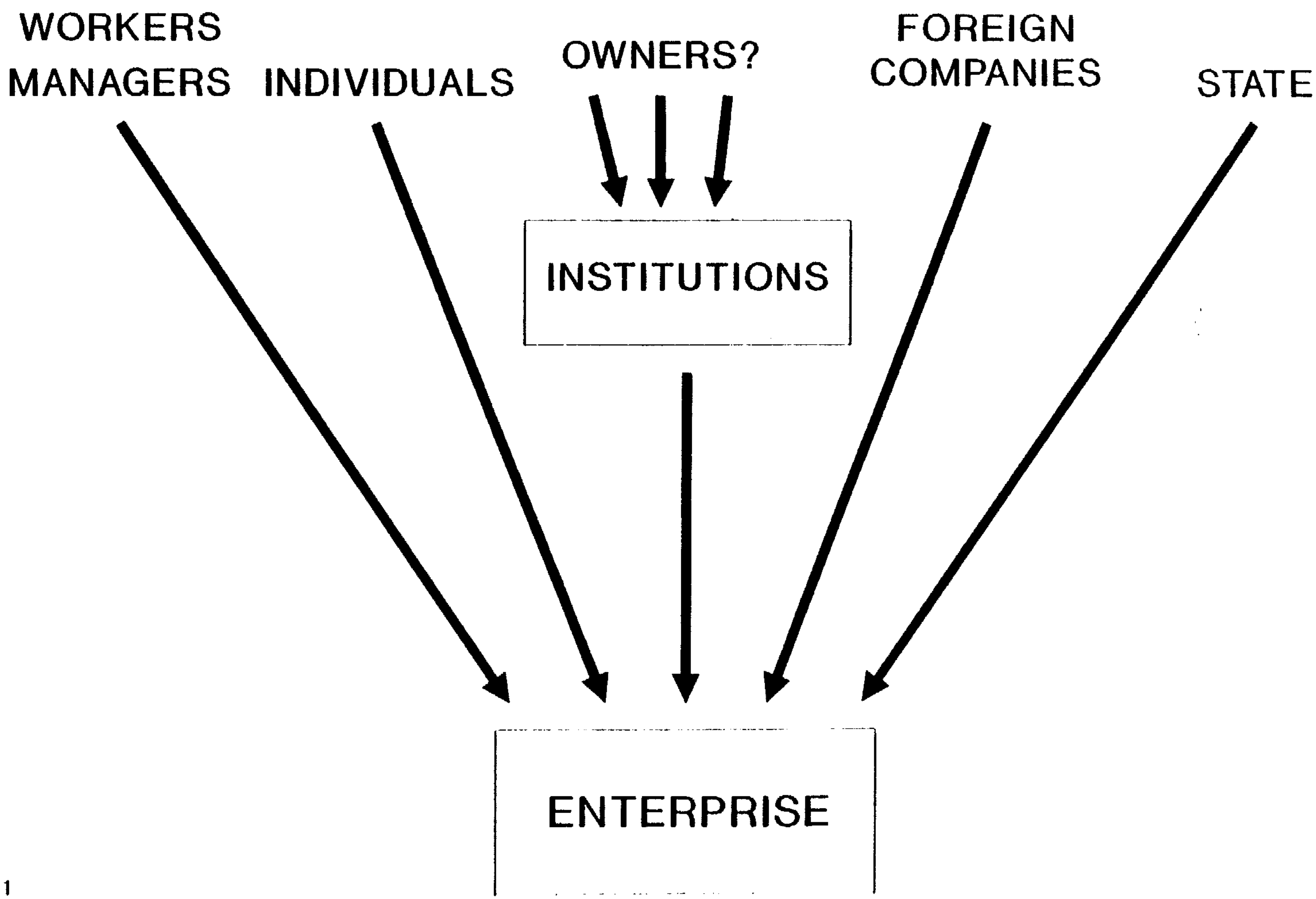
↓

WORKERS

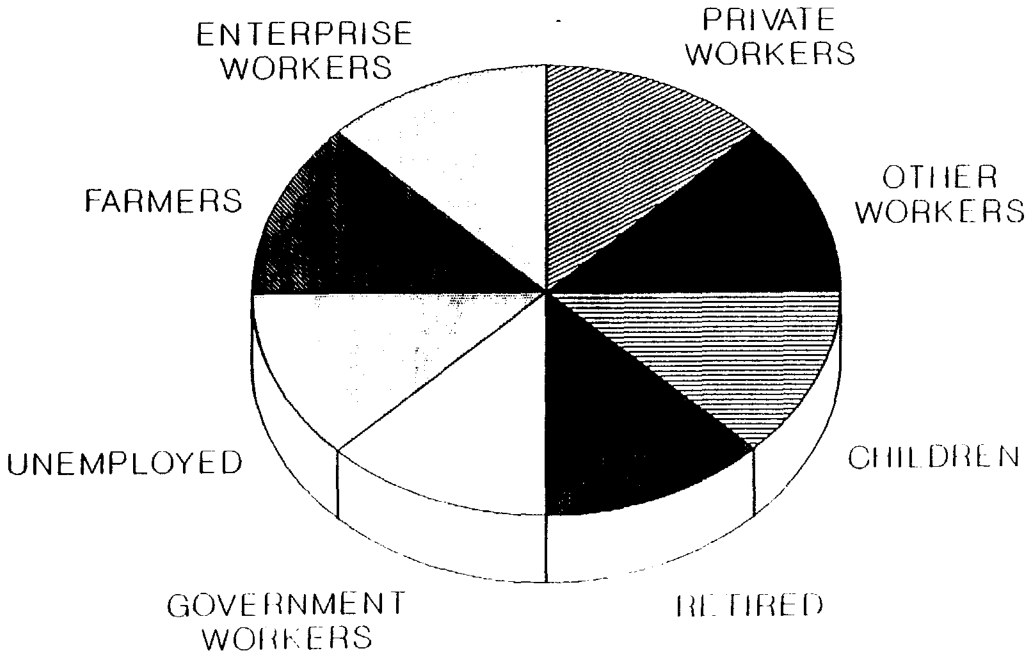
KEY ELEMENTS OF CORPORATE GOVERNANCE

- INTERESTED & EXPERIENCED OWNERS
- BOARD OF DIRECTORS
  - EXPERIENCED BUSINESSMEN
  - REPRESENT OWNERS
- MARKET PRICE FOR SHARES
- AUDITED FINANCIAL STATEMENTS
- TAKEOVERS

WHO WOULD BE THE BEST OWNERS?



WHO HAS A CLAIM TO A PIECE OF THE SOCIAL CAPITAL PIE?



PROBLEMS OF "HYBRID" ECONOMY

- NO OWNER
- NO PARTY CONTROL
- BOTH SOCIALLY-OWNED AND PRIVATE ENTERPRISES
- RESULT:
  - MANAGERS IN CONTROL
  - STEALING OF ASSETS
  - ONE-SIDED JOINT VENTURES
  - SPONTANEOUS PRIVATIZATIONS
- CONCLUSION: RAPID RESTRUCTURING

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FOUR MAIN OPTIONS

- STATE OWNERSHIP
- SALE
  - DOMESTIC/FOREIGN
  - FAST/SLOW
- SHARE GIVE AWAY
  - DIRECT
  - VOUCHERS
- INSTITUTIONS
  - BANKS
  - PENSION FUNDS
  - MUTUAL FUNDS
  - HOLDING COMPANIES

DISADVANTAGES OF STATE OWNERSHIP

- CONFUSED OBJECTIVES
  - PROFIT/COMMERCIAL
  - SOCIAL
- UNABLE TO JUDGE PERFORMANCE
- POLITICAL INTERFERENCE
  - PATRONAGE
  - REGIONAL
  - ETHNIC
- NO QUOTED STOCK PRICE
- TAKEOVERS NOT POSSIBLE

FAST FOREIGN SALE

- LOW SALE PRICE
- UNFAIR TO YUGOSLAVS
- BIG IMPROVEMENT IN CORPORATE GOVERNANCE
- NEW FOREIGN CAPITAL
- LIMIT ON FOREIGN OWNERSHIP?

FAST DOMESTIC SALE

- DISCOUNTED SALE PRICE
- NOT FAIR OR EQUITABLE
- LITTLE IMPROVEMENT IN CORPORATE GOVERNANCE
- IMPACT ON INVESTMENT?

VALUE OF SOCIAL CAPITAL

TOTAL	$60 - $130 BILLION
PER CAPITA	$2,500 - $5,000

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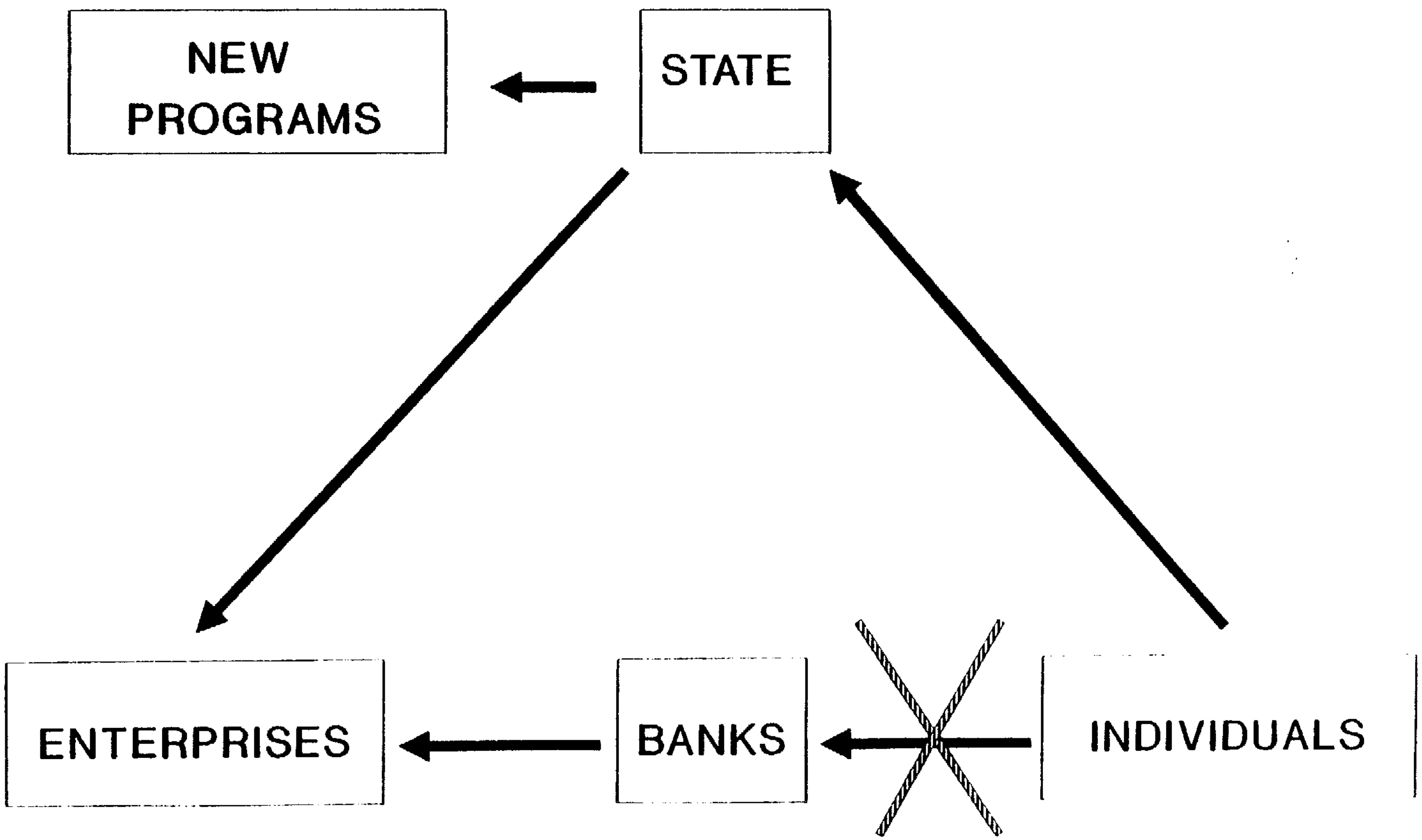
SOURCES OF FUNDS TO PURCHASE SOCIAL CAPITAL

EXISTING DOMESTIC SAVINGS	$12 BILLION
ANNUAL SAVINGS	$5 BILLION
FOREIGN DEPOSITS	?

IMPACT OF SALE ON INVESTMENT



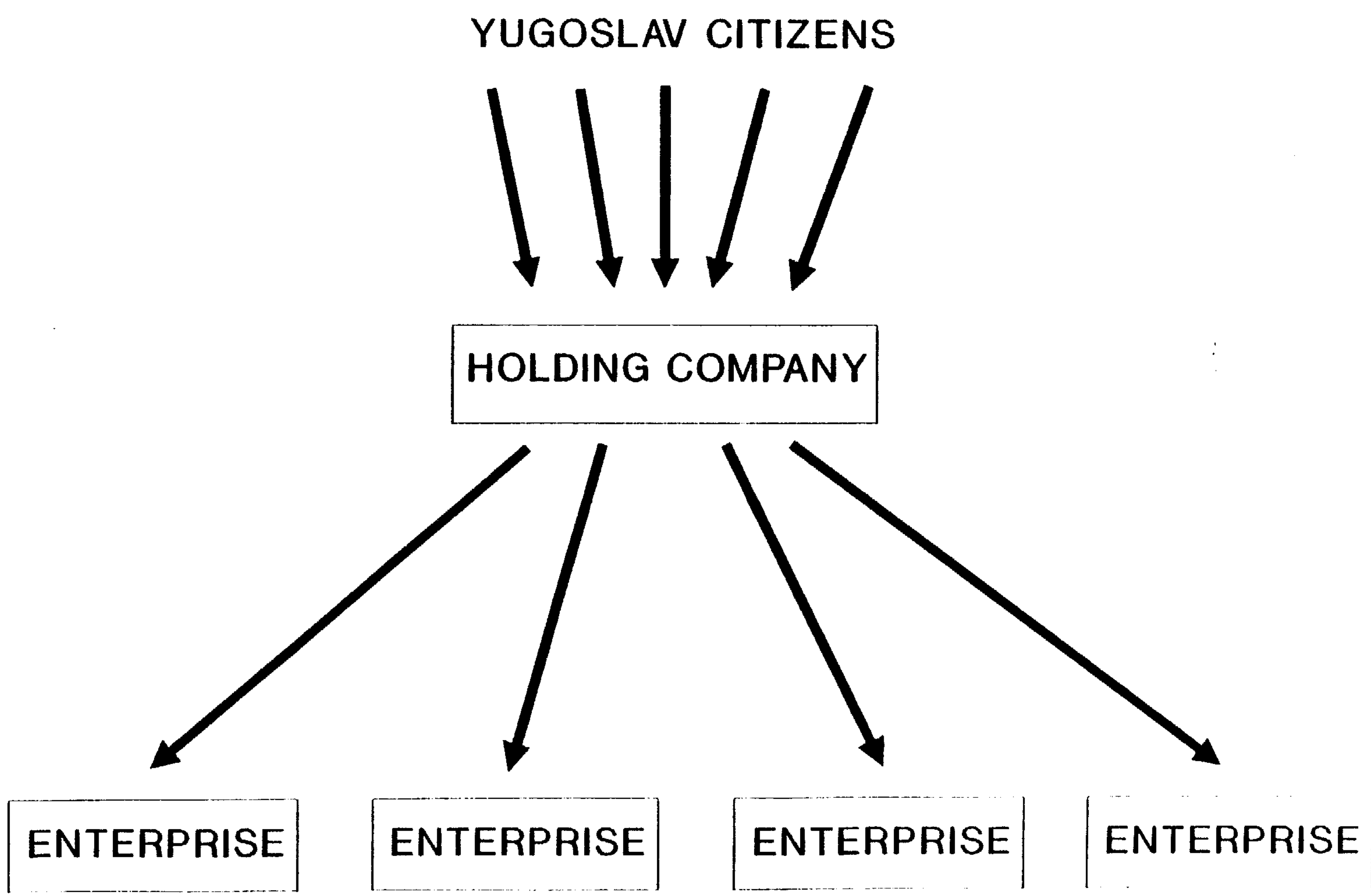
FEDERAL/REPUBLIC LAWS ON OWNERSHIP RESTRUCTURING

- "SPONTANEOUS PRIVATIZATION"
- THEFT OF ASSETS BY MANAGERS
- NEW ECONOMIC EXPERIMENT
- EXCLUDES OUTSIDE INVESTORS

SHARE GIVE AWAY

- DIFFICULT TO BE FAIR
- LITTLE IMPROVEMENT IN CORPORATE GOVERNANCE
- INCREASE IN CONSUMPTION AND INFLATION
- COMPLICATED TO ADMINISTER

HOLDING COMPANIES



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POLISH MASS PRIVATIZATION

DISTRIBUTION TO:	%
Lead Fund	33
Other Funds	27
Workers	10
State	30
TOTAL	100

PROPOSAL BY PROFESSOR SACHS

DISTRIBUTION TO:	%
Pension Funds	20
Mutual Funds	30
Banks	10
Workers	15
Development Fund (for sale)	25
TOTAL	100

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OWNERSHIP OF A TYPICAL ENTERPRISE

DISTRIBUTION TO:	%
Holding Company	30
Main Bank	10
Pension Fund No. 1	5
Pension Fund No. 2	5
.	
.	
.	
Pension Fund No. 9	5
Workers	15
TOTAL	100

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RECOMMENDED OWNERSHIP

DISTRIBUTION TO:	%
Pension Funds	45
Holding Companies	30
Banks	10
Workers	15
TOTAL	100

INSTITUTIONAL OWNERSHIP IS BEST

	GOVERNANCE	EQUITY	SPEED	OTHER
STATE OWNERSHIP	LOW	HIGH	HIGH	TAXES
SLOW SALE:				
DOMESTIC	MEDIUM	HIGH	LOW	INVESTMENT
FOREIGN	HIGH	HIGH	LOW	
FAST SALE				
DOMESTIC	LOW	LOW	HIGH	INVESTMENT
FOREIGN	HIGH	LOW	HIGH	
GIVE AWAY	LOW	HIGH	HIGH	CONSUMPTION
INSTITUTIONS	MEDIUM	HIGH	HIGH	TAXES

ANNEX III

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VEČERNJE NOVOSTI
December 27 1991.

THE GOVERNMENT ANNUL THE TELEVISION LICENSE

* The state is still the formal owner of New Zealand television, but it has to act like a private enterprise and earn its living from advertizing * Minister is like any other viewer (citizen)

In New Zealand today the state owned television acts the same way as the private ones. Although it is owned by the state, it still has to earn its living from advertizing. On the other hand state owned television is not obliged to make social and noncommercial programs anymore, nor to build relays to serve remote areas.

Before this reform, which came after the decision of the government New Zealand to increase efficiency in her 19 state owned enterprises, the state had a monopoly on television just as it is now for Television Belgrade.

Earlier, commercial and social goals connected with the television were the responsibility of one of the governments' agencies, the Broadcasting Corporation, which had a monopoly on providing television services. It earned its living from citizens television licenses and advertizing - says Dr. Robert Anderson, expert from an American firm "Coopers & Lybrand" who was hired by the government of New Zealand under a very ambitious program of economy reconstruction, and for the same reasons he is now in Yugoslavia. The Corporation was expected to cover the whole territory with its network, including remote villages and to make programs for developing the cultural life of the nation. Expenses of these social goals were covered up by the television license fees and advertizing, and as long as the Corporation had the monopoly, there wasn't a possibility that it will loose viewers to some other television company.

Managers of the Corporation mostly made decisions on their own about social goals which they were to achieve, as well as the amount spent, so that the state wasn't in the situation to control the efficiency of this enterprise.

In order to solve this problem the government decided to separate commercial and social goals and to bring in competition. All restrictive regulations, were mostly removed, so private television stations started to work. The new state owned enterprise called Television New Zealand took over the previous commercial functions of the Corporation (and the possibility to earn income from advertizing) and had an obligation to inform the Shareholding Ministers - says Dr. Anderson. Wider social goals were taken over by the independent Commission for Broadcasting and Commission for Broadcasting Standards.

After these changes the Commission took over the money from the television licenses, and made decisions about which programs should be broadcast (opera, symphony, noncommercial spectacles, programs for education). There was an open advertisement for this money so that all television networks could compete for it. The Commission's task was to receive all complaints about television network programs

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from citizens and react if there were something indecent on television (pornographic films at noon or similar).

It happened once that the state owned television brought out a program with accusations against the Prime Minister. Since it would be very unpopular for the Prime Minister to fire the manager of the television company (although he is his superior), he also had to complain to the Commission for Standards, as any other citizen, and then look for justice in the courts - says Dr. Anderson.

In any case this kind of organization in television has shown to be better than the one before, because thanks to advertizing the income of television increased, and because of competition, the quality of the programs improved.

There is one more thing that the government of New Zealand had done that our cabinet and parliament could use as an example while dealing with the request of the SPO Party that television Belgrade permits STUDIO B to broadcast on one of her channels. Building relays in New Zealand is the task of the Commission for Broadcasting, and every television station for a low price can put their antennas on them and that way reach everyone in the country.

ANNEX IV

Second CEEPN Annual Conference
on

PRIVATIZATION IN CENTRAL AND EASTERN EUROPE

November 29-30, 1991
Vienna Austria

REVIEW AND COMMENTS
BY
ROBERT E. ANDERSON*

INTRODUCTION

The CEEPN second annual conference on privatization in Central and Eastern Europe was held on November 29-30, 1991, in Vienna. This paper reviews and comments on the papers and discussion at the conference.

The Central/Eastern Privatization Network (CEEPN) has been organized to share information and experience among Central and Eastern European (CEE) countries undertaking privatization programs. The CEEPN was founded by Marko Simoneti (Director of the Agency of the Republic of Slovenia for Privatization) and is headquartered in Ljubljana. CEEPN is sponsored primarily by the World Bank.

The format of the second annual conference was somewhat different from the first held in November 1990 in Ljubljana. The participants were primarily officials from the various privatization agencies in the CEE countries. The sessions were usually chaired by staff of the World Bank.

Only a limited number of observers from Western countries such as myself attended and were not encouraged to participate. This perhaps reflects the view that Eastern European countries can now mostly learn from each other and that Western experience with privatization is not very relevant. After two or more years of experience with privatization in some of these countries, the participants have gained considerable expertise.

The participants who had the most to contribute were those from Poland, Czechoslovakia, and Hungary. Rumania, Bulgaria, and Yugoslavia had less to contribute while the smaller delegations from the Soviet Union and the Baltic countries mostly listened.

OVERVIEW

Compared to the previous conference, there was less discussion of the merits of different overall privatization strategies and more on implementation. The major emphasis was on the problems encountered in attempting to sell enterprises with less emphasis on so-called mass privatization methods such as creating ownership funds, vouchers, or giving away shares. This undoubtedly reflects the fact that most of the staff of the privatization agencies at least in Czechoslovakia, Poland, and Hungary are heavily involved in the difficult task of attempting to sell enterprises.

In fact, there seemed to be considerable opposition to "grand schemes" developed by Western academic experts that promise quick and easy mass privatization. The participants tended to refer to their programs as "multi-track" or "multi-channel", in other words, simultaneously using all approaches and techniques for privatization. My impression, however, was that selling enterprises one-by-one was in fact the dominant form of privatization now being tried by these countries.

*Dr. Anderson is a Director, Management Consulting Services, Coopers & Lybrand. Since January 1991, he has been advising the governments of Yugoslavia on privatization under a contract with the United States Agency for International Development. The views expressed here are entirely the author's and do not necessarily reflect those of the United States Agency for International Development.

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The following does not attempt to give a summary of all the presentations and papers. Instead it is my interpretation of some of the key trends and insights to be gained from the conference.

STATUS REPORT

Though the three leading countries (Poland, Czechoslovakia, and Hungary) have created substantial bureaucracies to manage the selling of enterprises, progress to date has been limited with regard to the large state-owned enterprises. Substantial success, however, is reported for small and medium sized enterprises.

With regard to larger enterprises, Poland has sold 16 enterprises. Hungary claims to have sold over 300 enterprises, but other sources indicate that only two of these were completely sold. The Czech Republic has just received about 1,700 privatization plans developed mostly by the managers of the enterprises. These plans must now be evaluated and implemented. One option is to place all or part of the shares of these enterprises in the "voucher" give-away scheme discussed below.

With regard to smaller enterprises, Czechoslovakia has sold over half of its smaller business units (13,000 units) at an average price of about $40,000. This low price may reflect the fact that real estate and property rights were only included in one fourth of the cases. In Poland, 667 small and medium size enterprises were privatized. Another 1,000 sales are planned. In Hungary, 703 shops and small business have been sold and another 900 are in process.

A common feature of the privatization programs for smaller enterprises seemed to be that this task was delegated to local governmental bodies of one sort or another. It was not centralized in the national privatization agency.

Rumania and Bulgaria have not yet begun privatization of smaller enterprises. This issue is probably not relevant for Yugoslavia since most businesses such as stores and restaurants are part of large chains.

MANAGEMENT/EMPLOYEE BUYOUT

The most popular method of sale has proven to be the purchase of an enterprise by the managers and employees who have a strong incentive to buy the enterprise in order to preserve their jobs. In contrast, Western countries have many private investors with both the capital and the knowledge of the business necessary to become owners of state-owned enterprises offered for sale. Such investors are few in CEE. The managers of these enterprises may be the only people in the country with the knowledge of how to run them.

The obvious problem with management or employee buyouts is that these individuals lack the capital to buy the enterprise. In effect, the government is forced to loan these buyers the money necessary to buy the enterprise. Often the old enterprise is liquidated, but the assets are transferred to the managers and employees under a leasing arrangement or deferred payment plan. The risk is that the buyers will not make the enterprise profitable and thus default on their deferred payments to the government. The enterprises would then return to state ownership.

With such sales, the government must continue to be involved with the management of these enterprises for some years. The government must either collect the deferred payments or take over the enterprise in the event of default. It can be said that the government has not really sold the enterprise but has become more of a partner with the managers and employees in an attempt to make the enterprise profitable.

Though there is some limited experience with management/employee buyouts in Western countries, this is not the dominant form of ownership in these countries. It is hard to predict how an economy might perform if this were the dominant form of ownership.

JOINT VENTURES

Joint ventures with foreign investors have gained somewhat of a bad reputation in some countries. In this form of privatization, the existing management transfers assets of a state-owned enterprise to a newly created enterprise jointly owned by the enterprise and a foreign investor (the "joint venture"). The joint venture agrees to compensate the state enterprise in some way for these assets, for example, through partial ownership of the new joint venture or lease payments.

In Poland, the complaint was that these arrangements amount to privatization but are under the control of a separate agency for foreign investment. In exchange for offers of lucrative employment with the new joint venture or other financial

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rewards, the managers of the state enterprise may agree to a deal that unfairly benefits the foreign investor.

PUBLIC SHARE OFFERING

Some enterprises have been sold to the general public through a widespread share flotation (also called an initial public offering or IPO). For example, Poland has sold ten enterprises in this way. The complaint has been, however, that the performance of the enterprise has not improved because the thousands of new owners have no control over the managers. In other words, such widespread share ownership does not result in better "corporate governance."

SPONTANEOUS PRIVATIZATION

Spontaneous privatization has come to mean any method of privatization whereby the existing managers of an enterprise propose a privatization plan or implement the privatization. It was pointed out at the conference that almost all approaches to privatization in Eastern Europe involve the managers developing a plan for privatization. The staffs of the privatization agencies simply do not have the time to develop plans for more than a few enterprises. Even the representative of the German Truehandanstalt with its 3,000 employees said that they were forced to rely on privatization plans developed by the enterprise managers.

This term has also come to symbolize the constant battle that is occurring between the enterprise managers and the privatization agencies in which the agency attempts to stop the managers from carrying out a privatization plan that unfairly enriches the managers. Not surprisingly, the managers wish to control the privatization so that they preserve their jobs, they can buy the assets at low prices, or they benefit in other ways. This basic problem was discussed by a number of the participants.

As pressure for faster privatization develops, the privatization agencies may simply have to accept more and more plans from the managers without adequate review and control. Since the managers are often the former "nomenclature" of the communist regimes, this would probably bring additional charges of corruption and stealing of assets.

This problem has lead to the emphasis on government valuation of enterprise assets. Slovenia is developing a list of "certified" appraisal or valuation companies that will review and approve the value of the assets being sold to assure that the enterprises are sold for fair market value.

Similarly Hungary is developing a list of "approved" financial advisors who can supervise the privatization of enterprises on behalf of the privatization agency and thus control the managers. In effect, the privatization is being contracted out to these approved financial advisors. It is hoped that these advisors will protect the interest of the state (the seller) in order to preserve their reputation and future status as an "approved" advisor.

THE GERMAN EXPERIENCE

A representative of the Truehandanstalt described their experience with the privatization of enterprises in the former East Germany. A common reaction of the participants was that this experience was interesting but not very relevant for other countries. Though there are important differences between the German case and the rest of the CEE, I found the German experience very relevant. It is the one successful example of the rapid privatization of thousands of enterprises primarily through sale.

In many respects, the task of the Truehandanstalt was easier than in the rest of CEE. It has about 3,000 employees brought in from West Germany trained in Western principals of accounting, finance, law, business management, etc. In contrast, the privatization agency in Poland has 400 employees while the Czech agency has 150. Moreover, a complaint by the conference participants was that the better staff leave for more lucrative positions in the new private sector and that the government does not provide adequate funding. Because East Germany was brought under the legal and political system of West Germany, "foreign" investors (ie from West Germany or other Western countries) felt much more comfortable in purchasing enterprises from Truehandanstalt than is likely to be the case in other CEE countries.

In spite of the large staff, Truehandanstalt also had to rely on a "bottom up" approach or spontaneous privatization where the enterprises developed their own privatization plans. In this regard, Germany is no different from other CEE countries. Truehandanstalt also used a decentralized approach for the sale of thousands of small

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businesses primarily relying on local governmental authorities.

In my view, the most surprising development was the emphasis Truehandanstalt placed on achieving various social objectives instead of simply maximizing the sale price of the enterprises. This seemed to be a change from the initial objectives of the organization. In effect, the government of Germany turned over to the businessmen running this corporation various tasks that are normally reserved for elected politicians and government officials.

The most important social objective was to preserve employment. To this end, Truehandanstalt would often accept a lower sales price in exchange for guarantees that the buyer would maintain certain levels of employment and invest new capital into the enterprise.

In many if not most cases, the only valuable asset of an enterprise was its land. To stop the new owner from simply buying the enterprise in order to shut down the enterprise and use the land for another purpose, Truehandanstalt in effect required the buyer to continue to operate the enterprise and to invest new capital. The end result was that the one valuable asset in East Germany, land, was sold to subsidize employment.

Other social objectives of Truehandanstalt are to split up large conglomerates to enhance competition and foster small business development. Also Truehandanstalt accepted any residual environmental liability but had a risk sharing clause with the buyer so that the buyer would have an incentive to reduce the cost of clean up.

I was disturbed by this development in the Truehandanstalt because it seemed to be an invitation for other CEE countries to use privatization as a means for achieving a whole host of social and political objectives. The other participants were interested in this aspect of the Truehandanstalt experience, for example, how to write and enforce the guarantees included in the sales contracts. If other CEE countries follow this example, the risk is that the whole privatization process will become bogged down in conflicting political, economic, and social objectives. In my view, such political and social objectives are best left for other government programs.

POLISH MASS PRIVATIZATION

One track of the Polish multi-track approach to privatization is the transfer of ownership of some enterprises at no cost to National Investment Funds. In turn, ownership shares in the Funds would be distributed free to the general public.

The hope is that this would result in both the rapid privatization of enterprises and improved corporate governance. The Funds would be expected to be active owners. They would monitor and supervise the performance of the enterprises with the help of foreign management consulting companies under incentive contracts.

It appears, however, that this program is being scaled down and is running into some political opposition. The number of enterprises in the program has been reduced from 1,000 to only 30 at least in the initial stage.

Two main arguments against the program have been advanced by various political groups:

- it is somehow immoral to give away the shares in the Funds without payment. The Hungarians also seemed to view that sale of enterprises was the only "market" approach to privatization and that any other approach was somehow socialist in nature; and
- the public will sell their shares in the Funds at low prices to a few clever people thus leading to a very unequal distribution of wealth in the country. To counter this last argument, the shares in the funds can not be resold until the funds publish their first financial statements.

CZECH VOUCHER SCHEME

The other major mass privatization program discussed at the conference was the free distribution of ownership to citizens using vouchers now planned in Czechoslovakia. Each citizen may purchase vouchers at a low price which then can be used to buy shares in enterprises.

The first step is that enterprises are required to submit a privatization plan that may propose either selling the enterprise or inclusion in the voucher program. This first wave of 1,700 plans are now due in the privatization agency for the Czech Republic.

The privatization agency will then review the plans and decide which to accept. A minimum of 20 percent of the shares in every enterprise must be included in the voucher scheme. This assures that at least part of the shares of the profitable companies are included. If the agency rejects a plan involving sale, then all of the shares of that enterprise may be included in the voucher scheme.

It is hard to get a clear understanding of the objectives of the voucher scheme. Its main advocate, Dusan Triska, seems to view its objective as encouraging citizen involvement in the new capitalist system. For this reason, Czech citizens must pay a price for the vouchers equal to about one weeks salary just to participate. This is to encourage them to take the process seriously and to devote considerable time and effort to deciding which enterprise shares to purchase. He expects that two million citizens (about 1/6th of those eligible) will participate.

Instead of using the vouchers to buy shares directly, citizens have the option of turning over their vouchers to newly created investment funds. These funds will then use the vouchers to buy shares in enterprises. The funds must be Czech funds, i.e. foreign owned funds can not participate. Also a fund can not own more than 30 percent of the shares of any enterprise.

The new schedule for implementing the voucher plan is that the auctioning of the enterprises will begin in April 1992 though problems remain. The administrative apparatus to carry out this huge auction seems to be in place. For example, a computer network with terminals in many post offices has been installed to process the orders for shares.

One concern expressed by the privatization agency is that a lot of work still needs to be done both to select and prepare the enterprises to be included. For example, some kind of a prospectus needs to be prepared for each enterprise, a board of directors appointed, and any restitution issues resolved.

The other participants had at least two objections to this plan:

- it would not improve corporate governance since the ownership of enterprises would be spread among thousands of participants. Triska predicted that the number of owners of a particular enterprise would not be greater than 2,000. The funds may also play an active role in corporate governance. However, their role could be greater if they could own more than 30 percent of the shares of an enterprise and could be foreign controlled or managed
- voucher holders will not be able to make sensible decisions about which firms to buy because of a lack of information about the enterprises to be sold. In effect, the purchase of shares may be little different from a lottery where shares are just distributed at random. It would also lead to "insider" trading where a privileged few know which are the good enterprises to buy. Triska said that this underestimated the ability of the Czech people and that the funds could help those unable to chose for themselves.

In spite of these weaknesses, the Czech strategy is the only one that seems to promise a quick guaranteed privatization. If a plan to sell the enterprise proposed by the managers is not acceptable, the enterprise is then placed in the voucher scheme and the enterprise is given away to voucher holders.

CORPORATE GOVERNANCE

One issue only briefly mentioned is the governance of enterprises during the intervening period until they can be sold. If privatization through sale is going to take a long time, who will act as the owners of the thousands of enterprises in the meantime to assure that they are well managed and as profitable as possible and that the managers and employees do not proceeds to steal most of the assets for themselves?

The participants seemed to be primarily interested in selling enterprises and felt that corporate governance was the responsibility of the old sectorial ministries that supervised the enterprises in the past. One participant complained that the sectoral ministries wanted instead to get into the privatization business because that was the exciting new area. Poland does have a plan for "corporatization" where enterprises will be converted into joint stock companies. Thus far about 3 percent of the enterprises (214) have been corporatized but it was unclear who is to act as owner for the state until they can be sold.

ROMANIA

Though new to the privatization game, Romania seems to have adopted one of the grand schemes that many of the other conference participants oppose. The Rumanian scheme is to immediately transfer 30 percent of the shares of all enterprises to five Private Ownership Funds. The shares of the Private Funds would then be given at no charge to all Rumanian citizens.

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The other 70 percent of the shares would remain in a State Ownership Fund until this Fund can sell the shares. Until the sale, the State Fund would be responsible for the performance of the enterprises including restructuring and liquidation if necessary. The State Fund is supposed to be an independent agency operated and managed on entirely commercial principles.

Because the setting up of these funds will take time, Romania intends to sell eight enterprises immediately. This is called "early privatization."

The criticism of this type of grand scheme is that it is really nationalization and central planning in disguise. It is argued that these funds will really be controlled by the government and not follow commercial principles. It is a way for the government to keep control of the economy while paying lip service to privatization. A proposal to transfer ownership of enterprises to funds in Slovenia was also criticized by conference participants as an attempt by the politicians to gain control over the enterprises that are now self-managed by the workers.

There is some support for this suspicion in Romania. The boards of directors of the five Private Funds are to be appointed by the government -- not the shareholders. It is argued that it is administratively impossible for the millions of shareholders to vote for the boards of directors. Similarly the government will also appoint the board of the State Fund.

CONCLUSION

Considerable progress has been made since the first meeting of this group a year ago primarily in establishing the various privatization agencies and gaining experience with the sale of a limited number of large enterprises. The privatization of smaller enterprises seems to be a success.

The problem lies with the privatization of larger enterprises. The participants tended to refer to their programs as a flexible, multi-track approach and did not want to be a slave to some grand theoretical scheme. Critics might instead call the programs slow, unclear, and experimental with no clear end in sight. Though called multi-track, in fact most of the programs are oriented towards selling enterprises as the primary method of privatization. Except in Czechoslovakia, mass privatization schemes are making little progress.

Though selling enterprises is the primary focus of the privatization agencies, they dismiss the German experience as not relevant. In fact, selling enterprises in most CEE countries will be much more difficult than in Germany. Since the CEE countries have only a small fraction of the people, resources, and skills that can be devoted to a sale program and foreign investors have less interest in buying enterprises compared to Germany, selling enterprises is likely to be a very long process in these countries.

One way to speed up the process is to accept the privatization plans developed by managers with little review or control. Such plans, however, are likely to involve some form of management/employee buyout financed by the government and designed to enrich the managers. The alternative way is to spend more effort to develop mass privatization schemes based on giving shares away either directly to citizens or to various types of existing or new institutional owners (funds, banks, holding companies, etc.).

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