

The Strange Kind Of Corporate Governance

Dejan Erić, Institute of Economic Sciences, Belgrade, Serbia

KEY WORDS : Corporate Governance, Management, Control, State

IEL : O16, G30

ABSTRACT: *The paper refers to the development of corporate governance phenomenon in the Federal Republic of Yugoslavia (FRY) during the 1990s of the twentieth century. It is about the country established by disintegration of the former socialist Yugoslavia, which was in the immediate war zone, under the United Nations' sanctions a full eight years and had one of the most undemocratic regimes in the world. In those circumstances, under the influence of factors from external environment, but also in a situation of unfinished privatization and transition processes and almost complete centralization of entire social and economic life, the specific forms of corporate governance developed, that did not bear much resemblance to the practice in other countries. Many ex-socialist countries of the Central and Eastern Europe which at that time were in the initial phases of transition also faced certain "childhood illnesses" characteristic of the corporate governance development. That was a logical consequence of the long-standing existence of socialist systems, absence of private ownership, the real corporations and market economy institutions. Meanwhile, however, it became possible to find adequate solutions too many problems and deviations. In Yugoslavia's case, the opposite trends and one strange kind of corporate governance have appeared, due to the rise of unusual forms of corporations, uncharacteristic ownership, and specific mechanisms of control and governance. In that situation, "childhood illnesses" were not adequately cured, but soon began to take on some degenerative forms. Since eventually the necessary political changes were effected in Yugoslavia in 2000, the bases for radical departures from the past and correction of many mistakes and misconceptions were formed. One of them has certainly referred to the departure from the strange kind of corporate governance.*

Introduction

Welcome to the story about one utterly strange kind of corporate governance. It will be analyzed on the example of a country that in the era of increasing internationalization and globalization processes during the last decade of the twentieth century tried to live isolated from the rest of the world. Under the undemocratic regime of one man and his politics, some strange economic processes and phenomena developed those were relatively unknown to contemporary economic theory and practice. Hence, this story could be similar to travelling to some attractive and exotic destinations. Or, perhaps, to one of the episodes of *The Space Tracks* series when *Captain Spock* with his crew landed on some new planet. They soon noticed that certain forms of life existed there, but not the ones known to the rest of the world or the ones they were used to.

The country we are going to talk about is the Federal Republic of Yugoslavia (FRY), that at the beginning of 2003, officially changed its name into Serbia and Montenegro. It is located at almost the very heart of the south-east region of Europe, in the Balkan Peninsula, bordered by Hungary to the north, Romania and Bulgaria to the east, Albania and Macedonia to the south and Bosnia and Herzegovina and Croatia to the west. It was established after disintegration of the former Socialist Federal Republic of Yugoslavia (SFRY) and constituted of the two then remaining republics – Serbia and Montenegro. The time frame we are interested in is the period between 1992 and 2000, when the civil war raged in that region, while the FRY was almost all that time under the regime of severe sanctions imposed by the United Nations.

One could ask himself – why the title of the paper is exactly the strange kind of corporate governance? The reason lies in the fact that in the Federal Republic of Yugoslavia during the mentioned period certain elements of corporate governance have existed but not in the form known to

economically developed, or as we shall refer to it in this paper, - "normal" world. In order to explain the strange kind of corporate governance an analysis will be focused on four basic elements:

- Corporation - as a business organization with its ownership divided into common stocks.
- Ownership rights and property relations – which are considered to be protected and completely clearly defined.
- Corporate management – who is expected to show a high level of responsibility, efficiency and effectiveness; and
- Appropriate institutional environment – which encompasses the whole set of factors, such as a reliable legal system, developed stock market or stock exchange, larger number of financial institutions, precise accounting standards, independent experts, the existence of appropriate know-how and system of information, etc.

If we were just a bit more critical of what happened in Serbia and Montenegro during the 1990s we could already assume that little of what we have just mentioned actually existed at that time! Namely, there were no true corporations, almost non-existent property right protection, no efficient and effective management, or appropriate infrastructure to support that. All resembled the situation when *Captain Spock* landed on almost desert planet, with seemingly no visible traces of life. We now come to one very crucial moment regarding this paper, when we could simply conclude it by stating that the practice of corporate governance did not exist in the FRY. However, if we give up a further analysis we would commit at least two mistakes. First, we would unreasonably waste your precious time by reading the previous part of the paper and second, we would miss the chance to learn about one extremely strange form of corporate governance in the world context. Therefore, since *Captain Spock* is still a very determined man, he finally managed to find something that showed some signs of life on seemingly dead planet. So did we. And we stay in this story, so if we scratch little further under the surface we shall see that in essence there are certain elements of corporate governance, but "pretty" malformed and extremely peculiar.

Finally, why would someone write about corporate governance in the FRY, that is, Serbia and Montenegro anyway? There are several possible answers. First of all, this region has not been researched so far, either in the country itself, or abroad. After dethroning of Slobodan Milosevic from the position of authority and power, both republics are in the process of accelerated transition towards market economy, which should imply a fast break with the past. The country still has big economic problems, relatively low level of gross domestic product and extremely low living standards of its citizens. This is why the mistakes from the past should be identified and many accumulated problems solved. It is necessary to find the ways how to finish the already begun process of privatization in as short time as possible and raise the entire efficiency and effectiveness of management and business operations of economic subjects. In that sense, an issue of corporate governance is gaining so much in importance. Eventually, there is one more important reason – the author himself lives and works in that country. Maybe he would prefer to write about corporate governance in Italy, France or Nebraska, but he happens not to be from these regions.

The paper, that analyzes the strange kind of corporate governance, will be divided into four parts. In the first part, we shall emphasize some of the most important characteristics that the "normal" types, that is, the usual kinds of the world corporate governance excel at. The second part points out a certain manifestations of deformed corporate governance in the FRY. The third part deals with some specific issues of the former socialist countries and characteristic environment of the FRY that contributed to emergence of the strange kind of corporate governance. Finally, in the fourth part we shall focus on certain specific features of the strange kind of corporate governance in Serbia and Montenegro during the 1990s.

The most important features of the "normal" corporate governance

There are many possible approaches to researching the field of corporate governance. No matter what and which approach or method we choose to analyze, it is practically impossible not to mention the three indispensable elements (*Robert Monks & Neil Minow, 1995*):

- Corporation
- Ownership and
- Management.

This approach implies, first of all, that in the economic structure of a national economy there must exist public corporations with certain tradition which is quite disparate from country to country. Although certain elements of financing by way of selling shares in the specific business ventures can be traced back to the ancient Greece (in regard to commercial travelling of ships) and Rome (building of roads and waterworks), the roots of modern corporations can be found with emergence of joint-stock companies during the sixteenth and at the beginning of the seventeenth century. Among the first mentioned there were *Muscovy Company* of the London trader Sebastian Cabot founded in 1553, and more famous and renowned *United East India Company*, established on March 20, 1602 in Holland (*Robert Sharp, 1989, pp. 7-16*). Some companies such as for example *Hudson Bay Company*, set up in 1670 in England still exists today. *Adolf Berle and Gardiner Means (1932)*, professors at Columbia University, pointed out that the origins of corporate system in the USA dated back to the beginning of the nineteenth century, when there were about "335 profit-seeking corporations, 219 turnpikes, bridges and canal companies". The development of industry, transportation, trade, and later banking contributed to their foundation and strength. Modern corporations that appeared in the USA and the UK at the beginning of the nineteenth century have continuously been developing for more than 200 years. There were times of great rises, but also occasional falls, and scandals. Still, what is most important the development has proceeded without violent interruptions. Thus, we can claim that the tradition of corporation development is something that presents the exceptional value and wealth of the West world!

The second major element which if left out would make corporate governance analysis practically impossible to perform is the property right protection and clearly defined property relations. All this is hard to exist without an efficient system, in the first place legal system! In the case of "normal" systems the things are crystal clear – a corporation issues stocks, stockholders have voting rights they use at the Stockholder's Assembly in order to choose Board of Directors, whose main role is to protect the interests of stockholders. This means that the third, unavoidable element of corporate governance analysis must be efficient management who is responsible to owners for corporation performance, primarily with regard to the creation of shareholders' values (*Alfred Rapaport, 1986*). The owner's welfare is being created by dividend payments or capital gains, which presents the basis for a manager's assessment. In the West, especially in the USA and UK, there is a built sense of responsibility and a high level of awareness regarding the interests of owners handed down from generation to generation!

Sometimes in relations between the owners and managers some agency problems and costs could arise (*M. Jensen & W. Meckling 1976, E. Fama 1980*). These occurrences are primarily the consequence of spreading the corporate ownership to a great number of individual stockholders. These situations demand a separation of ownership from control what the already mentioned *Adolf Berle and Gardiner Means (1932)* wrote about back in the 1930s. They differentiated between the five basic types of control:

1. Control through almost complete ownership
2. Majority control

3. Control through a legal device without majority ownership
4. Minority control
5. Management control.

In developed countries these five types of control are present even today to a lesser or greater extent. Each of them has certain specific characteristics, but no matter the type, the rules are absolutely clear. It is very hard to talk about the above mentioned types of control in the case of socialist countries, as Yugoslavia essentially was. Private ownership did not exist until the end of the 1980s, so none of these types of control could completely and independently develop.

Many researchers in the field of corporate governance have identified different types and approaches. Thus *Marco Becht*, for example, a German economist and executive director of the European Corporate Governance Institute in Brussels pointed out that there are multiple models of corporate governance developing around the globe (*Business Week*, 2002). *David O. Beim & Charles Calomiris* (2001, pp. 213) went one step further in order to be more specific and identified four primary models of corporate governance around the world:

1. State ownership and control
2. Family ownership and control
3. Bank-centered control systems
4. Control by dispersed shareholders.

We shall return to this classification somewhat later. Since our intention is not to go deeper into the problems of corporate governance in "normal" systems, we shall now point to some of the current questions that are of professional interests of the West researchers. Those are:

- o How to pay executives and members of the Board of Directors;
- o How to compose the Board – with regard to proportion between insiders and outsiders;
- o More efficient regulatory system in order to prevent manipulation, fraud and other illegal matters, better system of information and prevention of information asymmetry;
- o Creation of new disclosure standards;
- o How to create more democratic forms of corporate governance and corporate monitoring;
- o The role of institutional investors;
- o Accounting practice – how to improve it in order to inform the owners and the general public as objectively as possible;
- o Improvement of business operations of financial analysts and other experts in this field;
- o Leadership development.

A few notes in favour of the strange kind of corporate governance

In order to fully understand the story about the strange kind of corporate governance we shall ask you one very simple question – what would you think of if you learned about the following situations:

1. A Minister of the government is a member of several Boards of Directors simultaneously, even in those companies that belong to the same industry.

2. A company owes money to employees for 18 unpaid wages. In explanation of unsettled debts, the company says that they are in crisis and deep financial problems. On the other hand, the Director is putting pressure on his employees to sell him or give him over their stocks they got through privatization process. Those who refuse to do that – receive notice of dismissal and dismissal wage.
3. A Director is purchasing equipment from a foreign partner. To partner's big surprise the Director demands invoice increase by almost 50% provided that the difference between the effective and invoice price the company is going to pay should be transferred to his private account in a foreign bank.
4. A Director of partly privatized company keeps the stock certificates locked in the company's safe and does not want to share them to the owners, but demands from them instead to give him a three-year proxy.
5. The Director and the members of the Board of Directors invite workers who are at the same time stockholders to give them over blank stock certificates, without any explanation or compensation.
6. The Minister of the police is at the same time the President of the Board of Directors of the same company that exports weapons to the country under the UN embargo on those activities. When the scandal breaks, he does not accept any responsibility, arguing that "he has not been informed about it".

Believe it or not, these are some of the typical situations of economic life in Serbia and Montenegro during the 1990s. We hope you will understand that for objective reasons we did not give the names of the firms or individuals, but you can be sure that the events, of course with a certain degree of simplification, have been realistically depicted. Can you sense even now that on the basis of six aforementioned situations there is room for analysis of the strange kind of corporate governance?

Different researches have been conducted in the world regarding the models of corporate structure and governance. One of them refers to *Rafael La Porta, Florencia Lopez-de-Salinas and Andrei Shleifer (1999)*. They conducted studies of control structure of the 10 largest firms in each of 27 different countries. They used ownership of 20% or more as a definition of control and reported that 36% companies are controlled by dispersed shareholders, 30% are family controlled, 18% are state controlled, 5% are bank controlled and about 10% are in the hands of different categories. A huge problem in our case is that this kind of research does not exist in Yugoslavia. Hence, all our evaluation will be based on observation and the use of case study methods. Applying the classification of the four basic models of corporate governance we can claim now that during the 1990s the situation in Yugoslavia was as follows:

1. State ownership and control - The state-owned companies in the FRY did not exist until 1992, when Milosevic nationalized many big enterprises in the field of power production and distribution, manufacturing, oil industry, mining industry (e.g. gold mines), postal services, rail transportation, etc. This form of corporate governance has certainly existed since then, but with specific mechanisms of control that we shall write about somewhat later. At this point, it should be stressed that those were most often natural monopolies without any competition, controlling already limited resources.
2. Family ownership and control - This type of corporate governance does not exist until the middle 1990s. Since then it has begun to develop only in its rudimentary forms. The reason is very simple. The first private companies in Yugoslavia could be set up as late as 1990. A period of couple of years was too short to enable this form of corporate governance to de-

velop in its full swing.

3. Bank-centered control systems –This type existed only partially and in a very specific form. It was a strange mixture of the bank investments and their ownership structure that can be seen in Case number 1. Namely, the bank stocks were extremely unattractive financial instruments to many investors. In order to solve the problem many banks offered their stocks in return for obtaining credits, which was probably the unique example in the history of banking! As a consequence, we had a structure in which the biggest bank stockholders were the biggest debtors as well, which created many problems in the functioning of the Boards of Directors and operational management.

Case No. 1. – Who is the owner of whom?

According to legal provision in force, at the beginning of 1990s all banks in the Federal Republic of Yugoslavia were transformed into corporations. They began to issue stocks, but it soon turned out that there was a weak interest of general public and almost nonexistent demand on the part of investors. To make the issue of their stocks more attractive some banks started to stipulate that their clients - depositors – should first buy their stocks – and then the banks would allow them credit, give guarantee, open a Letter of Credit or perform some other bank transaction.

That the matters started to be very serious the best evidence was the fact that when making decisions to issue a new series of stocks the banks included a right to open a credit, obtain a guarantee and open a Letter of Credit, together with voting rights, dividend rights and others. In that way, Serbia (in which there were more cases like these though) has become an extremely innovative country in the areas of banking and stock ownership, which were then and are still unknown to the modern world.

To raise a credit, the Yugoslav firms had to buy stocks from their banks. However, since there were no severe legal sanctions for those who defaulted, many big, especially socially-owned and state-owned enterprises ever returned the credits they raised. In that way the banks became big creditors for many companies, which gave rise to a strange mixture of ownership and debtor structure – where the biggest stockholders were at the same time the biggest debtors. It was a paradox that almost the same people who were the members of the Board of Directors were also the members of the Credit Boards. You can only imagine what the line of decision-making about many important matters looked like! On the other hand, the banks' accounts receivable due but not yet paid were converted into owners' shares, and there goes another paradox – the bank was one of the owners of the same company that was one of the bank's stockholders. Very often in those circumstances it was hard to tell who was the owner of whom!

Epilogue – at the end of 2001 four biggest Serbian banks that were most involved in those business transactions went bankrupt.

4. Control by dispersed shareholders - This type of corporate governance in the FRY certainly did not exist, not even in the slightest possible form. One should not disregard the fact that the first corporations were established only at the beginning of the 1990s, alongside the initial stage of privatization process. Nevertheless, those processes were not entirely completed in the next 10 years, so that even nowadays it is very hard to talk about the existence of true Anglo-Saxon type corporations in Serbia and Montenegro.

In addition, many institutions of market economy did not exist as well. Even when they did

exist, they were weak and undeveloped. Legal system was incomplete, corrupted and extremely inefficient. Accounting standards were obsolete, auditing practice was not used for such a long time, and the public was uninformed, uninterested and preoccupied with other, more important problems such as war, sanctions, or the mere survival.

Specific features of socialist self-management system and factors that affected the creation of the strange kind of corporate governance

In the beginning, we have to point out a couple of general factors related to corporate governance analysis which are important not only to the FRY, but also to many other ex-socialist countries in the region of Central and Eastern Europe. These are:

- **A lack of corporate governance tradition** – in developed countries the tradition of corporate governance is remarkably long, as for instance in the UK where the first joint stock companies appeared in the middle of the sixteenth and at the beginning of the seventeenth century. Serbia and Montenegro, as well as many republics of the former Yugoslavia did not even exist at that time as independent states. They were under the rule of either Austrian or Turkish Empire. The whole region stayed undeveloped for long time. The first traces of industrial development can be found in Serbia only at the end of the nineteenth century. The origins of the Belgrade Stock Exchange can also be traced back to that period. It was founded in 1895 as one of the oldest stock exchanges in the Balkans. However, frequent wars were the cause of interruptions in its development. In Serbia's case, there were a lot of these periods – from 1914 to 1918, when Serbia was occupied, and then from 1941-1989 – formally, but basically up to 1997. In other words, out of 120 years of possible development we have a discontinuity of almost 60 years. We are of the opinion that it is such a long period.
- **Political terror of socialism on economy** – hereby we imply in the first place the dominance of planned approaches to economy that inhibited the market functioning. Managers of socialist enterprises are not used to keen competition such as the one that exists on the world market. The capital officially does not exist in socialism, since all assets are either state or socially owned. Therefore, there is no capital market as a vital ingredient of financial market. There is also no need for any financial instruments such as bonds or stocks. In those conditions, market mechanisms become suppressed while politics has absolute control over economy.
- **State and social ownership** – brought about a specific form of economy and business organization governance. State ownership led to centrally planned management, which was the case in the USSR and other countries of the Warsaw Pact. In the former SFRY the situation was somewhat different – it was characterized by distinct elements of workers' self-management and so-called "associated labor", that gave rise to appearance of specific approaches to management – so-called self-management. Since private ownership did not exist and self-management was so dominant that practically meant that the ownership function was not separated from management.
- **The practice of "soft budget constraint"** – which means that in certain situations the state was ready to cover the part of the company's losses. Consequently, the socialist companies and managers did not face a high level of responsibility and risk of bankruptcy.
- **Special environment of Serbia and Montenegro** – refers to a set of factors that contributed to the appearance of specific corporate governance during the 1990s. Those factors are first of all: war in immediate environment, war psychosis, sanctions imposed by international community, isolation, scarcity of most important resources, a fall in the gross domestic product, a decline in industrial production, a fall in foreign trade (exports and imports), hyperinflation,

monetary chaos, increase in unemployment (more than 20%), a drastic fall in the living standard and disappearance of the middle class, moral degradation and a strong desire of one man for absolute control and power.

The Socialist Federal Republic of Yugoslavia (SFRY) was seemingly perfect example of ideal system for theorists of socialism. Social ownership made possible that the means of production were really controlled by those who worked with them. Since the employees formally own all the means of production, those who work make decisions as well, and consequently should take the responsibility. So where the problems came from? They were not theoretical problems, but they existed in practice. Just look at the Case number 2 - Seven wonders of communism – which colourfully depicts the way of thinking of people in socialist socio-economic systems.

Case No. 2 – Seven wonders of communism

1. Everybody had a job.
2. Although everybody had a job, nobody worked anything.
3. Although nobody worked anything, we realized all our plans at least 100%.
4. Although the plan was more than 100% realized, the stores were empty.
5. Although the stores were empty, everybody had everything.
6. Although everybody had everything, all (of them) were stealing
7. Although all (of them) were stealing, nobody ever lacked anything.

("Blic", a daily newspaper, Belgrade, December 14, 2002)

One of the basic problems of socialism was a chronic inefficiency of business operations. It was manifested in an array of irrationalities that on the other hand led to other problems such as an increase in costs, exclusive orientation of employees to get wages with neglecting long-term objectives and investments, growth and development; that all contributed to a decline in competitiveness of economy, both on domestic and international level. For increasing economic failures nobody was held responsible, which in the first place put an emphasis on (ir)responsibility. On the other side, there were no market economy institutions, no financial markets, stock exchanges, financial instruments and efficient mechanisms of creditors' protection. In that way, there were no external factors and pressures that could restrain and punish management inefficiency, either through bankruptcy or takeovers, that is, by way of functioning of market for corporate control (*Henry Manne, 1965*).

The specific system of corporate governance in Serbia and Montenegro during the 1990s originated exactly from the socialist Yugoslavia, where a unique system of ownership existed, which except partly in Israel (kibuci) has not been recorded anywhere in the world. This is – social ownership – which implied that the owners of certain means of production are those who in fact perform business with them (*Encyclopaedia of Economics, 1994, pp 233*). Ownership in the SFRY presented rather political, philosophical and social issue than economic or legal one. Social ownership was not essentially state ownership similar to other socialist countries of the Central and Eastern Europe. It was the property of "all working people and citizens", what according to theoreticians of self-management socialism in the SFRY was one step forward to a communist ideal that assumed a complete control over means of production by the workers themselves. Those phrases were very frequently quoted and used as proofs of great humanity of socialist systems and superiority of self-management and social ownership. However, there was still one unresolved question in practice –

if all the workers are owners, who has the real power, that is, who takes the real control?

Looking for an answer to the above question, we can trace the origins of specific features of the corporate governance system in the FRY during the 1990s. In all socialist countries, the SFRY being no exception, the Communist Party and its structures had the real power. The Communist parties in many countries were the most powerful and the best organized structures. Through their bodies, political party cells and secretaries they were in a position to control not only all economic organizations, but also all the activities in the society. The managerial positions were allowed only to those who were members of the Communist Party. The similar situation was in the SFRY as well as later in the FRY!

Slobodan Milosevic until his dethroning on October 5, 2000 was undoubtedly the most influential and the most powerful man in the FRY. Officially a socialist (he was the President of the Socialist Party of Serbia), deep in his soul a communist (he had an enviable political career in the Communist League of Yugoslavia, the only and leading party in the former SFRY), he proved himself in the real political life as dictator and tyrant. At the beginning of his rule, he proclaimed himself a reformer and protector of the national interests. However, it soon became evident that using the old party model of economic governance he only wanted to strengthen his power. In his attempt to accomplish this goal, he took advantage of the external environment and its circumstances, for which he was also personally very responsible (he is currently standing trial at the war-crimes tribunal in the Hague). First of all, there was a disintegration of the SFRY, followed by an outbreak of very cruel civil war, first in Croatia, then in Bosnia and Herzegovina. Starting from 1992, the FRY was under the United Nations' sanctions, which apart from smaller easing off were effective the following eight years. Having been in constant isolation, the country inside suffered from suppression of democracy and democratic freedoms; the atmosphere of fear and general insecurity was being spread; the different phobias were being developed culminating in national frustration. The economy also experienced the infringement and suppression of economic freedoms, the state of complete centralization and the whole country resembled more than ever the communist systems of the Soviet type. These are just a few characteristics of the general social environment in the FRY during the 1990s.

Economically speaking, some of the major factors that should be mentioned are:

- Economic structure dominated by social and newly established state companies ranked in order of strength.
- The emergence of the first private companies which were still very economically weak. A more serious growth and development of the private business could only be made possible by huge back up of the political elite.
- The already started privatization process (in 1990) but soon brought to a halt (during 1993-1994) and the existence of extremely indefinite property relations in one part of economic subjects.
- Suspension of workers' rights and the formal suppression of the workers' self-management. This was a direct consequence of a high level of general social insecurity that Milosevic skilfully took advantage of in 1992 by amending the *Company Act*, where he informally abolished self-management, giving extremely great authority to company directors.
- A developed political party structure inherited from the Communist League of Yugoslavia (ex-Communist Party).

Under these conditions, the first corporations and the first elements of corporate governance were created, followed by a series of "childhood illnesses". Were it not for the fact that the country

was isolated and under the sanctions and the political scene dominated by undemocratic system, Serbia and Montenegro would have probably been cured of many of those illnesses after only a couple of years as many other countries in transition. Nevertheless, the above mentioned conditions gave rise to a degenerative development of corporate governance we label as the strange kind.

The specific features of the strange kind of corporate governance

The basic specific features of the corporate governance in the Federal Republic of Yugoslavia during the 1990s can be analyzed by specific characteristics of the four basic elements we formulated at the beginning of this paper. Therefore, in the FRY we had:

1. The strange kind of corporation
2. The strange kind of ownership
3. The strange kind of management and control
4. Undeveloped institutional environment

Regarding the fact that all the elements were specific, it logically follows that they have resulted in the strange kind of corporate governance.

1. The strange kind of corporation –We can freely claim that in the FRY during the 1990s there were no true corporations of the Western type, especially not of the Anglo-Saxon type. The corporations officially did not exist from the beginning of the Second World War in 1941 up to 1989 when the *Company Act* laid the foundations of re-establishing privately owned enterprises. The first corporations were officially set up at the beginning of the 1990s. They originated as a consequence of privatization trends, where the social capital was first evaluated, then shared into certain number of parts, that is, stocks, which were later granted to the employees depending on their years of employment. However, since those processes were not fully completed we had therefore the emergence of the strange kind of corporations!

Yugoslavia is probably holding the world record in number of trials to complete the privatization process. This process has been started many times though, but just as the entire process of transition too, it has never been fully conducted, because in the first place it lacked both the true political readiness and support. Only in Serbia in the period of 10 years five different privatization acts have been passed (1990, 1992, 1994, 1997, 2001). If we do not take into account the last one, passed after Milosevic's fall – then we are talking about four different acts that put an emphasis on the different privatization models. However, privatization effects were extremely poor. The economic structure was still dominated by social and state companies ranked in order of strength and size. What presented a particular feature of the development of corporations in the FRY was the existence of corporations of mixed ownership, that is, a combination between private (stock ownership) and social ownership. Until the end of 2000, out of 6,000 social corporations in Serbia only 1,000 were partly privatized. A typical structure of those corporations was as follows: 40-80% of ownership was in the hands of individual stockholders (the number ranged from a couple of hundreds to a couple of thousands, mostly individual persons, often the employees, former employees and retired workers); the remaining part of ownership that amounted to 60-20% was still a social capital. Of course, many problems occurred in practice, in the first place concerning the election of the members of the Boards of Directors. Some more distinctive features of corporations in Serbia and Montenegro can be found in more detail in Case number 3.

Case No. 3 – The strange kind of corporation

The following cases can best illustrate to what extent the strange kinds of corporate governance did exist in the FRY:

- According to legal provision in force, it was possible to establish a corporation in which there was only one owner!
- According to Yugoslav acts, corporation as a form of ownership was termed A.D. (Akcionarsko Društvo – when translated - company with the shares or stocks). Many firms, in order to stress their importance put after their names - **Corporation A.D.** – which presented a real pleonasm. Particularly surprising was the fact that hardly any one in the public did really notice it was a pleonasm.
- All that time during the 1990s no corporation publicly made known financial information and business reports. The balance sheet and the income statement were treated as a top business secret.

A special problem regarding the strange corporations referred to their relationship to stockholders. In the FRY until the end of the twentieth century there were no generally accepted accounting principles (GAAP); the IASC standards (*International Accounting Standards Committee*) were also disregarded; there was hyperinflation, great monetary instability, a practice of "profit smoothing" that is, fixed financial reports; auditing did not come into existence for a long time; independent financial analysts also did not exist; the system of public information was very low because there were no obligation of public announcement of information; and there was a huge information asymmetry. All these are arguments in favor of our thesis that during the 1990s in Yugoslavia we had a **strange kind of corporation**, where on the one side there were individual petty stockholders pretty much unprotected, and on the other side there was still very powerful social capital, that increasingly took on the features of classical state capital.

2. The strange kind of ownership – An issue of ownership and property relations has already been dealt with in this paper. We wish to emphasize again that no legal regulations existed in Yugoslavia that treated the private ownership as inviolable. The reform of property relations was carried out very slowly. It was considered that a huge contribution to ownership reform was adoption of pluralism of property relations. It practically meant the co-existence of several forms of ownership, in the first place, private, social and the state ownership. These principles enabled the changes of legal regulations that were effected as early as 1989, which gave rise to a legal basis for establishment of private companies. Only in Serbia, in the period of couple of years, starting from 1989 until 1994, a number of business organizations increased from 10,000 to 200,000. As much as 95% of that number were privately owned companies. Although it could be said at first glance that the ownership structure of economy had radically changed, the practice showed that considering the strength and importance the socially and state-owned companies still dominated the economic scene.

Simultaneously with changes of ownership structure, the process of privatization started to develop. However, it has never been entirely effected. In that way one type of business organizations was created which was a mixture of property structure – partly social and partly privatized. These organizations started to take the shape of modern corporations, but also retained elements of social enterprises. The stakeholders were mainly internal stakeholders – from managerial structures and among the employees. That caused some confusion, since efficient mechanisms for the protection of their interests did not exist. In addition, many other financial instruments were not

fully developed as well. Thus, only common stocks existed, but due to a high level of ignorance and absence of tradition, they did not have the characteristics of those in the developed countries. There were no preferred stocks or multiple classes of stocks. What is even worse, the issues of debt finance and use of corporate bonds was also not regulated. This all contributes to the fact that there was a **very strange kind of ownership** in the FRY.

Case No. 4 – "Positive zero?!"

A zero in mathematics is always a zero. It does not have either positive or negative sign. However, accountants and managers in Yugoslavia introduced one innovation unheard-of in mathematics. It is a positive zero.

A positive zero is a very frequent expression exploited in the business jargon by managers, not only in Serbia and Montenegro, but also in other former Yugoslav republics. It was figuratively used to describe two kinds of conditions:

1) Acknowledgement that the firm had certain financial problems that they (managers) somehow managed to solve at the end of the year. In other words, the firm did not make a loss (because certain legal consequences should follow then, in the first place filing a petition in bankruptcy), but the balance sheet and income statement recorded neither losses, nor profits. In this case, the accountants would post-date many liabilities and costs for the next year, so simply there were no losses – according to financial results profits and losses were equal, that is, the bottom line would indicate zero profit or loss.

2) Looking for ways to evade profit tax payments. The concept of positive zero would be applied when the company was successful and made a certain level of profit. In this case the opposite procedures were affected, namely the profits were deliberately diminished and losses inflated so that the profit would somehow "melt" and soon be showed that the company's financial results were close to zero, which did not draw much attention of the public, tax authorities and political structures.

3. The strange kind of management and control – One of distinctive features of socialism referred to the fact that the directors and members of the manager teams had to be members of the Communist Party. The problem of political party membership of management constituted a part of their responsibility. For example, what if some good party "cadre" makes wrong business decisions and the company they run makes a loss? This was otherwise a very frequent occurrence in the SFRY. The question of responsibility was solved by so-called collective responsibility, which actually presented a way of avoiding individual blame. These things and practice did not change a bit in the Federal Republic of Yugoslavia during the 1990s. It was just enough to look at the structure of directors of the biggest enterprises in Serbia for instance. One would soon conclude that almost every one of them, without exception was at the same time a member of some ruling party. More interesting though was the fact that many of them did not have much faith in ideals or programs of those parties, but realized that it was the only and the safest way to help themselves and their companies.

At the beginning of this paper we mentioned the famous work of *Adolf Berle and Gardiner Means (1932)* in which they made a difference between the five basic types of control: control through almost complete ownership, majority control, control through legal devices without majority ownership, minority control and management control. Many of these types of control simply could not exist in the Federal Republic of Yugoslavia since there was no private ownership. The control was manifested in some other ways. Nevertheless, during and especially at the end of the

1990s these questions increasingly gained in importance. This assertion especially refers to management type of control, that started to be very prominent but in some rather specific forms. We can now ask ourselves – What was in fact the real control of corporations in bigger part of the observed period?

One of the basic criteria for selection of managers (either directors or members of the Boards of Directors) of the state, social and mixed companies was not professional qualifications, education, capability or results, but loyalty and obedience! That means that there were actually no clear standards. Often the term "selection" meant "appointment" as in the good old communist times. During the 1990s, the Federal Republic of Yugoslavia was a country isolated from the international community. Due to exclusion, the state itself started to lose many of its legal attributes and increasingly become party-state. The political parties (in the beginning – only one, somewhat later - many of them but with the same program) pervaded all layers of social and economic life. The real power was in their hands. Since social ownership still existed, while the society was controlled by the state and the state was the Party itself, party structures began to take over a central role in the control of economy. The party bodies appointed managers, members of the Board of Directors and the Supervisory Board of the social companies and mixed capital corporations (where social capital still existed in not completely privatized companies). In that way, the Party had control over the most important economic trends. There were no independent directors or members of the Board of Directors, because it was "important to have their own men in the key positions". The issues concerning manager compensation, their professional orientation or continuous education and professional training were completely pointless. Political parties were simply not interested.

Loyal and obedient managers got a certain degree of authority, which was validated by the 1992 *Company Act*. However, a high degree of authority was not followed by the high level of necessary responsibility. Many Yugoslav managers did not have to respect efficiency and effectiveness criteria, since these were not the most important parameters of their work assessment. Instead, they were trying so hard at any cost to keep the social peace and hierarchical system, having an opportunity to finish their "own" deals in return. Thus many managers of that time concluded business deals that were damaging for their companies, set up private firms through which they could "pump out" the assets of the social companies, employed their favorites and dismissed those they disagreed with without any responsibility, etc. There was no sense of responsibility to owners, since they were small and disunited. Besides, the owners were actually employees, former employees and retired ones who "must not refuse to obey" anyway and who were not even protected by appropriate legal regulations. Furthermore, they were smaller owners, since the biggest share of the capital was still socially owned. If there were no responsibility to owners then the basic goal of contemporary business organizations could not be achieved as well, i.e. creating shareholder value. There was also no true responsibility towards the society because it was in the state of fear and chaos. There was only responsibility to those who had a real power and control – i.e. political party structures. Therefore, in Yugoslavia we had **the strange kind of control** in action.

What happens to governance in those conditions? The great influence of the Party on economic life created a high level of manager dependency. If you make a loss – it is not a serious problem – "the society" will make up for the losses, in other words, there must be a way to help loyal and obedient "comrades" in trouble. If, by any chance, managers make a profit – then "it is only right to share it with the comrades." Domestic managers could never be sure what part of the profit they would really have at their disposal. Once more we stress that profit and success were not criteria for business performance evaluation. Only loyalty, obedience, and capability to finish certain jobs counted. Therefore, we have now **the strange kind of governance** as well.

Case No. 5 – How to help unsuccessful ones

The ruling parties have worked out a whole set of ways in order to help loyal managers who would get into troubles from time to time. The typical ways were:

- Transport of cash money in bags – which was particularly popular during 1993 when the biggest hyperinflation in the history of mankind raged in Yugoslavia. One of the participants in those activities told later that on one occasion there was a real panic when a truck full of money had broken down on the road. The whole city of Krusevac (about 150 miles away from Belgrade) got the salary not on Friday afternoon as previously planned, but on Saturday morning. Instead of buying 10 DM (about 5\$) with their average salary on Friday afternoon, the unfortunate citizens of Krusevac could barely buy 1 DM (0,5\$) on Saturday around noon
- Mechanism called "night smoothing" – referred to the way of temporarily covering the losses and negative balance on accounts. It actually implied transfer of financial means from accounts of economic subjects who had excess money into accounts of those companies that at the end of working day had negative balance. This was being effected during the night, when money was fictively transferred from account of one subject into somebody else's account, so that at least in the morning all would have seemingly positive balance and business operations of some of the companies would run uninterruptedly. During the day, everything would be the same as before, just "till the night comes" and there went "smoothing" again. Everything for "comrades" in trouble!
- Primary issue of credits – The Central Bank of Yugoslavia many times uncontrollably issued money and granted credits to many selected companies, most often to those that were the regime favorites. Thus those companies either covered their losses or bought foreign currencies in the street from citizens, did some questionable jobs, made profits and after a couple of months returned given credits, which by that time were already devalued by hyperinflation.

4. Undeveloped institutional environment (Undeveloped market economy infrastructure)

– In order to speak of "normal" kind of corporate governance in one country it is necessary that at least a minimum of market economy institutions and corresponding legal framework should exist. That did not exist in the Federal Republic of Yugoslavia sufficiently enough. First of all, there was no necessary political support to reforms. Many laws and acts were inherited from the former SFRY, legal system was slow and inefficient, and many state institutions corrupted. The state due to sanctions, isolation and the wars in immediate environment controls the most important flows of goods, money and capital. Monetary power is not at all independent. The crucial way of the state budget financing is by monetary expansion, which in turn brings about extreme rise in inflation and the general economic instability. The fiscal system is on the primitive level of development. The Stock Exchange exists only formally, but it does not function as a capital market. The broker-dealer organizations exist, but there is no financial instruments quality enough that could be traded with. Accounting standards are obsolete, incompatible with international standards and utterly unreliable. There is no adequate system of financial reporting and analysis. There are no clear obligations of disclosure. There is a lack of qualified and trained cadre. The public is not enough motivated or interested. Besides, stock ownership development simply does not suit political structures. Stock ownership essentially assumes the embodiment of economic democracy,

but to Slobodan Milosevic's regime any form of democracy was absolutely unknown.

Case No. 6 – "Believe it or not" column: The relationship to stockholders

The following examples can best illustrate what the relationship to stockholders in the Federal Republic of Yugoslavia really was:

In the spring of 1999, immediately before the NATO air strikes, a joint meeting of representatives of Securities Commission and a score of broker-dealer firms was held in Belgrade. The author of this paper was also present at that meeting as a director of one broker firm. The commission was obliged to do the following three things:

- To let broker-dealer companies to do business operations with physical subjects. They were not allowed to do that before, in other words they could do business only with economic subjects.
- To re-examine the Belgrade Stock Exchange commission on stock trade that accounted for 0,50% since the brokerage according to Commission decision was fixed at 0,40%. The brokers complained that on each realized transaction in stock trade they made at least a loss of 0,10%.
- To reconsider the possibility of cancelling pre-emptive right in secondary stock trade. Namely, this right was instituted in Serbia according to 1997 Privatization Act by which the stockholders were prevented to freely dispose of their stocks.

Although all the three demands seem perfectly logical or suitable for some "believe it or not" column – they were neglected without any justifiable reasons!

Epilogue – all three anomalies were removed soon after the political changes at the end of 2000.

Since corporations did develop in Serbia and Montenegro, but not the real ones, private ownership existed alongside vague social ownership. There was also a specific system of control, and the governance itself was rather political than economic concept – no wonder we write about the strange kind of corporate governance in this paper. Some of its main characteristics are:

- Specific conditions of its development – on the one side the absence of true political willingness for reforms and privatization, and on the other side, unfavorable influences of international environment that made the Federal Republic of Yugoslavia the most isolated country in the world during the 1990s.
- Non-existence of corporate development tradition – a discontinuity of almost half of century in stock ownership development.
- Existence of mixed ownership that implied a combination of outmoded social ownership that slowly disappeared and private ownership that slowly became stronger.
- Legal restrictions – a lack of adequate protection of both property rights and property relations.
- Insufficiently developed awareness of managers to respect owners' interests and insufficient level of responsibility.
- Underdevelopment of necessary market economy institutions and financial instruments.
- Almost nonexistent protection of shareholders' rights.

- Dominant influence of politics on the composition of the Boards of Directors and selection of managers.
- Disregard for efficiency and effectiveness criteria.
- Insufficient system of information of potential investors and the general public.
- Non-existence of developed accounting standards and auditing systems.
- A lack of professional personnel.

In the end, we can conclude that the problems of corporate governance development in Serbia and Montenegro are completely different from those that existed not only in developed countries, but also in other countries in transition. As to developed countries, it is perfectly logical - one should just take into consideration the differences regarding the economic development. We also particularly lay stress on discontinuation of market economy development and corporate ownership forms of business organizations. Socialism has been deeply engraved in the people's mind. Economic democracy, as well as political one takes time to develop. This is what both Serbia and Montenegro most lacked, so that certain initial problems of transition and so-called "childhood illnesses" have not been treated on time. What essentially distinguished the Federal Republic of Yugoslavia from other countries in transition was degenerative form of economic undemocracy that undemocratic political regime has introduced and created. Still, everything comes to its end, so does this kind of tyranny. In the reform processes that lie ahead of Serbia and Montenegro, it is extremely important to survey the initial state. We hope that this paper at least help a little in that regard – i.e. in identifying some of the problems of corporate governance development that need to be resolved.

Moral and conclusions

At the beginning of the twenty-first century Serbia and Montenegro are strongly determined to radically depart from the past. Consequently, the name of the new state community has been changed and the Federal Republic of Yugoslavia does not exist any more, even formally. Both republics strongly advocate integration into international political and economic trends. They expect an influx of fresh capital and foreign investments necessary for acceleration of economic growth and development. Their ultimate aim is to become full members of the European Union. However, they will have many problems and obstacles on that road. What should be borne in mind is the fact that without efficient economic subjects there is no efficient economy as well. In that sense, the experience of other countries lasting several centuries has proved that corporations represent one of the most efficient forms of business organizations.

Corporate governance began to develop in the Federal Republic of Yugoslavia during the last decade of the twentieth century, but in rather irregular conditions. In that way, besides "childhood illnesses" many other countries in transition have faced, here we also had some very specific conditions caused by the factors of external environment on the one side and undemocratic regime on the other side. Their activity gave rise to one degenerative and deformed practice and form of corporate governance on which political structures had far too great influence. This is as if you took a big dose of a medicine so that many side effects would result. In that regard we can freely conclude that both in Serbia and Montenegro we had one ill form of corporate governance that tolerated inefficiency, ineffectiveness and irresponsibility, so it could naturally not contribute to economic growth and development, or democratic tendencies either. The political changes effected in 2000 have finally provided the foundations for the nation's economic revival and departure from old practice.

Hence, one of the basic tasks of the new government authorities is to face the problems and find the ways to solve them. To accomplish these objectives, Serbia and Montenegro must make many efforts, starting from the protection of owners' interests, transformation of judicial system and institutions, raising of the general level of responsibility, improvement of morale and business ethics, to development and education of effective and efficient managers. All this is of course impossible without appropriate willingness of political structures. We deeply believe that there is such willingness this time and that Serbia and Montenegro will become very attractive investment destinations for investors from all over the world.

Literature

1. Adolf A. Berle and Gardiner C. Means (1932) »*The Modern Corporation and Private Property*«, Harcourt, Brace & World Inc., New York
2. David O. Beim and Charles W. Calomiris (2001) »*Emerging Financial Markets*«, McGraw-Hill, Irwin, Boston
3. »*Blic*«, Yugoslav newspaper, Belgrade, December 14th, 2002.
4. »*How to Fix Corporate Governance*« (2002), Business Week – Special Report, May 6, pp. 69-79
5. »*Corporate Governance Rule Proposals*«, Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors August 1, 2002, www.nyse.com
6. »*Encyclopaedia of economics and business*« (1994), Savremena administracija, Belgrade
7. Eugene Fama (1980) »*Agency Problems and the Theory of the Firm*«, Journal of Political Economy 88, pp. 288-307
8. Mark Grinblatt and Sheridan Titman (2002) »*Financial Markets and Corporate Strategy*«, 2nd edition, McGraw-Hill, Irwin, Boston
9. Michael Jensen and William Meckling (1976) »*The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*«, The Journal of Financial Economics 3, pp. 305-60
10. Rafael LaPorta, Florencia Lopez-de-Silanes and Andrei Shleifer (1999) »*Corporate Ownership around the World*«, Journal of Finance 54, pp. 471-517
11. Henry Manne (1965) »*Merger and the Market for Corporate Control*«, Journal of Political Economy 73, pp. 110-20
12. Robert A.G. Monks and Nell Minow (1995) »*Corporate Governance*«, Blackwell, Cambridge, MA
13. Alfred Rappaport (1986) »*Creating Shareholder Value – the New Standards for Business Performance*«, The Free Press, New York
14. Robert M. Sharp (1989) »*The Lore and Legends of Wall Street*«, Dow Jones – Irwin, Homewood, IL
15. »*Company Act*« (1992), Official Gazette of FRY, Belgrade