Crisis Period in Operation of Companies during their Transition from State-owned to Private

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Abstract: This paper gives a short presentation and critical analysis of property transformation of companies in this country. The analysis inludes the transition period from 1989 until the present day which can be termed the crisis period in operation of companies during their transition from state-owned to private. The authors have divided the analyzed the given period into four phases depending on the different legal regulations. This article deals with the positive and negative consequences and results of this complex, paradox, painful and yet unavoidable process which makes up the core of the general process of transition of the former self-government system into the current democratic society with a market economy. In the last part of the work the role of insolvency and reorganization will be discussed as a unique form of transformation of parts of remaining state-owned companies which are in a hopeless economic situation.

Key words: privatization, social capital, company, transition, insolvency, reorganisation

1 Introduction

While in developed market conomies in the 1970s and 80s the process of structural adjustment took place, Yugoslavia concentrated on the strategy of industrialization and the concept of autarchic development. The economic structure was charaterised by a high participation of the primary and secondary sector in the creation of social product and the accentuated priorities in the areas of energetics, raw materials and food. What made Yugoslavia quite particular in relation to other states was what was stated in the Constitutional resolution from 1974 and the Law on associated labour from 1976. The complete 'ourization' of the economy, thus the administrative-centralized system is replaced by the so-called self-government planning and joining labour with means. All this brought on the need for a specific strategy of privatization, which was supposed to handle all deficiencies of the extensive system

of self-government. With the need for reform changes rose the need for legal regulations in the area of ownership pluralism. *The process of ownership pluralism took place in several steps: ranging from the parallel existence of private and state-owned property over institutional framework which enables their parallel existence in the same economic subject, until the setting up of basis for the transformation of state-owned into other forms of ownership. Thus it follows that the disappearance and privatization of state-owned capital was solved by way of institutional control as well as via channels outside institutions, far away from the public.*

2 Initial Oeriod of Orivatization (1989-1991) – Phase I (legal regulation on the level of the Socialist Federal Republic of Yugoslavia)

Privatization in Serbia is regulated by several laws. Legal solutions differ in the suggested model of privatization as well as in the answers to two crucial questions: who the means from the sale of state-owned companies belong to; and who decides on the privatization process.

The transformation process of the Yugoslavian economy started with the passing of the Law on companies at the end of the year 1988. According to this law, the company becomes the basic organizational model of economy, profit is the basic motive for functioning and all forms of ownership are proclaimed equal. *The first law which opened the privatization process in Yugoslavia in the year 1988 is the Law on sales and management of state-owned capital.* The law was liberal, in the sense that it enabled the sale of businesses to domestic and foreign private individuals and legal entities, practically to anyone, including employees of the company. It enabled the sale of the entire company, parts of the company and various means.

The basic model was the model of sale. The companies were sold by way of auctioning:

1 When the company was sold to employees, there was the possibility of 'setting up' an unrealistically low price;

2 When there were no potential buyers:

3 When there were several potential buyers.

Besides the model of sale, the Law on sales and management of state-owned capital suggested other models too: the model of extra investments and the model of the conversion of debt into investment.

The practice of carrying out the Law (altogether 16 cases of the application of the model of sale) did not bring the expected results. The main weak points of the model: the decision about privatization was brought by the company, and the means from the sale were paid to the republican Fund. This deficiency was to be amended by the Law

on state capital and the Law on the payment of personal income from the year 1990. The Law on state capital had to motivate employees to bring the decision about privatization, because it was not very likely that a staff would make a decision through its self-governing body which rids them of their ownership rights. Besides, employees took no interest in the Fund, where the means from the sale would end up.

The Law on state capital enabled four models of privatization:

1 Model of extra investments;

2 Model of sale;

3 Model of converting debt into investment;

4 Various models of joint investment.

The model of extra investments – interest share, was introduced as a basic model of privatization. Internal sharea were sold with a discount of 30% compared with the real values of internal shares. The discount was increased by 1% by every work year. The overall discount could not exceed the limit of 70% of the value of those shares.

The next limitation referred to the sum of capital which could be formed in this way: to the mazimum value of 6 paid yearly incomes in the given company. The overall discount was written off to the burden of the state capital. If the company managed to fit into both limitations, it could almost 'melt' the entire social capital and become completely privatized. With the majority of companies these conditions were not fulfilled, thus instead of becoming privatized they became mixed-ownership companies. *Such a coexistence of private and social capital was short-lived due to excessive abuse of the social capital, as well as due to the lack of protection of ownerhsip and competitiveness, and also from fear of change of ownership structure of the overall capital to the benefit of the state.* Such change could only be stopped by the reinvestment of the profit of all other owners, which was highly unlikely. Except for the discount, the Law enabled the sale of a **CEGA** cheques on credit for up to 120 monthly installments.

The profit from the sale of internal shares remained with the company, which was a chance to carry out some financial consolidation, beside the re-structuralisation of ownership. The decision on issueing internal shares was made by the body responsible for the management of the firm. So the entire process was characterized by the principle of volunteerism and autonomy. The fact that a choice could be made between the accountancy value and the estimated value of the company based on which the shares were issued proves that these principles were indeed applied.

'The repurchase of internal shares would have been the dominant method of privatization. With this method around 3300 state companies were transformed in Yugoslavia (entirely or with over 50% private capital), which makes 12% of the overall number of companies, or around 13% of the social capital in Yugoslavia. The majority of companies were from Serbia, Bosnia and Herzegovina and Macedonia.' [8, 78]

The Law on salary also included the issueing of internal shares. Namely, this Law from the year 1990 enabled that one part of the increase in personal incomes be paid in the form of internal shares or bonds. That was an attempt to avoid new inflation pressure and, at the same time, accelerate the process of property transformation.

'Shares obtained by either one way or the other were related in the sense that the internal shares received as increase of salary could be transformed into those according to the Law on state capital. In this way the value of shares based on salary would increase the value of the confirmed discount' [8, 86].

The Law on social capital enabled various models of sale, thus making it possible for companies to choose the most convenient model. The Law also discussed a possible repurchase of the company with the re-investment of the Fund, which by investing into the company, became its co-owner. Further, among the allowed models was also the sale of debtors, in this way the company gained a new owner by means of an insolvency process. The buying of the company's means did not mean gaining owner's rights over the economic subject, but only over the means. The money from the sale of means remained with the company. By such procedure the ownership of the company was not decreased, only its accountacy form changed.

It protruded that the model of sale had countless limitations, in the first place was the insufficient purchasing power of the public, as well as a psycholgical resistance in the initial phase of the transformation. The Law on social capital offered the option on conversion of debt into investment of the current creditor who in this way became a co-owner of the company. Based on this the company transforms into a form of mixed ownership. The models of joint investment are carried out by way of a contract between the investor and the state-owned company. Thus the investor becomes a co-owner of the company to the degree of the value of the investment. The Law further enabled the renting of the company, leasing, franchising and other forms.

Based on the presented basic models of legal possibilities for privatization it can be concluded that there was a wide range of models, thus their application depended on the readiness of firstly the company, then the Agency and the Fund. For the first time the Law defines the formation of two institutions for privatization. The Fund for development was created as an investment organization which invests the means from sales into the same company, or even make a short-termed payment to the employess of the sold company in the form of securities of the company or the Fund. That was a stimulating measure for the employees to become involved in the sales process. The Agency for restructuring dealt with professional and consulting issues in connection with the sale of a company.

'Estimates say that until the end of the year 1990 privatized companies made up 71,6% of the overall number, while the percentage in state ownership made up 24,5%. However, the companies in private ownership were small, so the participation of the state-owned companies in the national product at the end of 1990 was around 80%' [8, 102].

3 Privatization (period 1991-1997) – Phase II (legal regulation on the level of the Republic of Serbia)

After the non-application of the federal Law, the member republics passed separate laws. Thus the Parliament of Serbia passed the *Law on conditions and process of transforming social property into other forms of ownership* as the basis for transformations which were not carried out according to the federal Law concluding with August 13th 1991, and for further transformation of social capital into mixed companies and for revision of already privatized companies according to the federal Law.

The basic principles of this Law are:

1 *Principle of volunteerism*, enables the companies to decide for themselves if they would carry out the transformation or not. Such freedom comes from the Constitution of Serbia which supports the equality of all forms of properties.

2 *Principle of public* obliges the company to publically announce the intended transformation, and inform all potencial buyers.

3 *Principle of protection of integrity of state ownership* and special observation is ensured by estimation of the value of the capital which is done by authorized organizations.

The Law specifically developed several models of transformation.

1 Issueing and sale of shares in order to sell social capital is a condition for employees to name a nominal value of shares of at least 10% value of the state capital, and for the management to underwrite shares in the value of their net income of the previous two years.

2 Model of sale of companies or part of them was enabled for domestic and foreign private individuals or legal entities by way of public auctioning or collecting of offers. The conditions of the sale were determined by the Fund when the contract was made. Simultaneously, the Fund was also where the money ended up.

3 With the model of renting the company and a contract for managing the company's operation the transformation of renting the company was regulated – both to domestic and foreign private individuals. If there was a repurchase of shares happening simultaneously with the renting, approval of the Agency for estimation of social capital value was needed for the signing of the contract.

Besides restricting stimulation for privatization with the republican Law compared witht the federal Law, the Republican Agency decreased the rate of successful privatizations by means of revision, abolished shares issued according to the Law on personal income and ordered taxes to be paid on shares issued in this way.

The restrictive nature of the first republican Law and the domination of politics over economy which was made possible with this Law largely slowed down the process of privatization, and by this made it less and less economically efficient.

4 Model of transferring capital to funds and recapitalization for the purpose of financial consolidation was applied in the case of large companies which were having financial difficulties. The Fund ensured recapitalization on the basis of direct investment in the company, or by repurchase of domestic or foreign debts of the company and converting these demands into their own investment. Furthermore, it played a large role in including banks into the process of property transformation, enlarging by this the banks' potencial and on the other hand, conditioning them to convert their demands into long-term investment into the company. The Fund was also a transitory institution, i.e. it took over companies in Kosovo by transferring shares, then sold them and thus initiated a constant change in ownership and management structure. In this way a certain consolidation and sanitation of large deficient companies took place.

Empirical data show that following a drastic decrease in the number of transformed companies in 1991 and 1992, in the second half of the year 1993 there was a radical rise in interest towards privatization. The reason for this was the accelerated rate of inflation and inflation profit. All this leads to the conclusion that in a more stable monetary situation the model of issueing shares with discount was more popular, while the model of capital sale was more used in the situation of accelerated inflation. The model of capital sale led to the eliminating of social capital (the limited sum of issueing with discount made up around ½ of the capital). The avoidance of re-evaluation led to the abolishment of the effect of privatization.

The total financial effects of privatization are difficult to calculate due to the monetary instabilty which marked that period. Due to weaknesses in the legal regulation, which did not state the re-evaluation of the estimated value on the day of the payment of shares, it came to a real 'end-of-season' sale of social capital. In consequence of this, the Parliament of Serbia ordered a new estimation of the companies' values to be done by the Agency. Also, a re-evaluation of the estimated values was ordered until the day of the payment. With the correction the structure of ownership changed radically. Namely, by this procedure the rate of privatization from the federal Law was heavily decreased. In this way the partaking of employees in the transformed companies fell from 90% to under 10%. Thus the process of ownership transformation was stopped.

4 Privatization according to the Law on Ownership Transformation from the Year 1997 – Phase III (period 1997-2001)

Understanding the necessity of ownership changes of social capital in order to increase efficiency and come out of the economic crisis various scientific institutes, political parties, syndicates and individuals made a wide range of suggestions about the choice of the most appropriate model for privatization.

Finally, in July 1997, the Parliament of the Republic of Serbia passed the Law on property transformation. The companies that completed the transformation of part of social capital according to the instructions of the Law previously in effect continued the transformation of the as-yet un-transformed part of the social capital in concordance with this Law. The shareholders from under the previous Law could continue the payment for the underwritten shares according to the definitions given in the Law of 1997 if that proved to be more profitable for them. According to this Law the subject of the transformation is the entire social and state capital that are at disposal of companies. The value of the capital is determined by estimation of the company itself that is to be transformed or by an authorized organization for estimation. The companies could transform autonomously, according to a specific plan of the government, or with the agreement of the founder.

Privatization under such conditions was carried out according to one or more models:

1 Sale of Bonds in order to Sell Capital (with without discount)

The process started with an estimation, decision on transformation and a public call for the underwriting of shares. Before the start of the first round a 10% transfer of the company was carried out to the Fund for pension and disability insurance.

In the first round 60% of the shares were dealt for free to beneficiary categories based on personal contribution to the creation of social capital (employees, previous employess, pensioners, farmers). In this way, free shares could be given away in a period of five years, though partially, in the first year 10% based on underwriting, in the second and third year 20% and in the fourth and fifth 25% each.

For the second round 30% remained which were sold at the discount of 20% and an discount of 1% for each working year there to the beneficiary categories of buyers, or at normal price to other interested domestic or foreign legal entities or private persons. The beneficiary buyers had priority in buying shares and the discount price could be paid in one sum, or by credit, using money of bonds of the Federal Republic of Yugoslavia based on the unpaid foreign currency savings. The shares with and without discount were issued after having been paid for.

The shares which were left unsold after the second round as well as those which in the end were not paid for after all were taken over by the Shares Fund by selling unlimited shares on the capital market. In this third round, too, the beneficiary categories had the priority of purchase. The shares taken over and being sold by the Shares Fund were shares without rights of management. Still, by their sale they became regular shares with rights of management.

Financial means made by sale of social capital were divided to the accounts of:

1 Fund for the development of the Republic of Serbia 50%;

2 Republican Institute for the labour market 25%;

3 Republican fund for pension and disability insurance of employees 25%.

2 Sale of Bonds in order to Collect Extra Capital (with discount)

The variation of recapitalization was advantageous because the means which the company made remained with the company. By property transformation by the model of recapitalization it came to an increase in the overall capital of the company, as well as to a change of owner structure, since besides the social capital shareholder capital also played a role.

3 Debt Conversion

The companies in debt in the second half of the 1990s could convert their monetary debt into shares with a discount of 20% of the sum of the converted debt. The total capital of the company to be transformed was thus decreased by the sum of the discount.

The privatization of individual large companies in difficult financial situation was carried out according to a special program of the Government of the Republic of Serbia by the application of the above-mentioned models. This was also valid for the companies of strategic importance which had debts larger than half the continuous capital, and which were insolvent for more than a year.

Public companies whose founder was the state were the subject of privatization only with the approval of the founder. The transformation is carried out by way of one of the three described models or the combination of them. The employees of the company had a small discount just like in social companies, however, the financial profit made from the sale of the state capital of the company to be transformed goes back to the state, thus the founder.

Due to these models of transformation a huge number of shareholders appeared. However, the question arises whether or not the worker-shareholder system is only the carboncopy of the system and situation established during the period of social ownership.

5 Current Model of Privatization – Phase IV (since the year 2001)

The Law on privatization was passed in the year 2001 and it defines the conditions and process of change of ownership of social as well as state capital With this Law and its surrounding regulations the most prolific institutional infrastructure for privatization was created: the Ministry for Economy and Privatization, the Agency for privatization, Share fund and the Central register for securities.

The models of privatization according to this Law are:

1 Sale of capital;

2 Transfer of capital without compensation.

The subject of privatization is the sale of 70% of the capital or less if the buyer does not accept such an offer. In the company to be restructured, in concordance with the Law, the entire capital is sold. The sale of the property is carried out by way of a public tender or public auction.

The company which satisfies the criteria in this aspect: size, strategic importance, number of employees and interested buyers – is privatized by way of a public tender. The tender is devided into three phases: beginning of the process, preparation of the tender and carrying out of the tender.

The beginning of the process is initiated by the company, the Ministry of economy and privatization or the potential buyer, by filing an initiative for privatization with the Agency. Following this the Agency publishes a brochure in the media with all the relevant basic information about the subject of privatization.

The preparation of the tender includes choosing a financial advisor for technical questions with the organization of the tender and selecting the most favourable bidder, then preparing the tender documentation, publishing the call and collecting the offers.

The third phase or the carrying out of the tender means opening the offers of those who bought the tender documentation, and by paying the deposit, presented themselves as serious bidders. The offers are evaluated by the Agency within a period of 30 days based on the following criteria: continuity of the operation of the company, investing into the company, social program, environmental protection, price offered. The buyer whose bid was deemed as the most favourable will sign a contract, the agreed price can be paid in domestic currency or bonds issued on the basis of unpaid foreign currency accounts. The buyer becomes the owner of the company as soon as he pays the total sum of the agreed price, minus the deposit.

The sale of capital by way of public auction is a method of privatization where potencial buyers publically compete under the agreed conditions. The process of auction happens in three phases: start of the process, preparation and conducting the auction.

The start of the process (initiation and publication of the brochure) is the same as with the sale of capital by way of a tender.

What is specific about this method of privatization is during the preparation phase which includes among others the evaluation of the capital, more precisely the range of value of the capital. The evaluation is conducted by the company according to methodology defined and controlled by the Agency. Two methods of evaluation are used. The first method is DNT, which represents the current net value of financial flows which the company will achieve working on the ‘going concern’ principle. This method includes financial analysis, projection of financial flows, defining the discount rate and the basic, bottom rate of the DNT value.

The other method of evalution is the method of insolvency value of the capital. The basic insolvency value of the capital is calculated between the insolvency value of the property and the sum of insolvency value of duties and costs of regular insolvency.

Conducting the auction begins when the auctioneer announces a starting price.

During the first auction, the starting price is 20% of the upper limit of the range value of the capital which is offered for sale as determined by the Agency for privatization. If there is an offer on the level of the starting price, the auctioneer determines a new price and calls upon the participants to meet the offer. The process is then repeated until the participants do not again meet the new price.

In case the first contest is unsuccessful, the second round is immediately started under the same conditions. If the first auction is announced unsuccessful, then there is a public call within 7 days for a second auction, with the difference that the starting price in the second auction is 20% from the bottom limit of the value range.

Employees have the right to obtain shares without compensation for each full working year spent in the subject of privatization, at most for 35 years of working period.

The right to obtain these shares is not granted to employees of companies where not more than 50% of social capital was sold, or of those companies which are being restructured.

According to the Official Gazette of the Republic of Serbia, the Službeni glasnik, Nr.45 there are vital differences in the sum of capital for obtaining shares without compensation with two models of capital sale. Namely, that sum with companies privatized by way of auctioning totals 30% of the entire sum of the capital, while in the case of a sale via tender, the sum is 15%. The other 15% is transferred to the Privatization register from which it will be divided between all citizens of the Republic of Serbia older than 18 years on the day when the decision of transfer of shares without compensation was passed, two years following the end of the privatization process. Employees of companies with major state capital are granted the right to shares without compensation according to special regulations. The reason for such a solution is the specific position of employees in companies with a given capital structure.

The Law on privatization includes the operation of one more institution. This is the Share fund – a specialized institution through which further sales of transferred shares are conducted, such as left-over shares of a company, shares of shareholders who withdrew from payment for the underwritten shares, etc.

6 Insolvency and Reorganization of Companies as Forms of Privatization

Insolvency is a necessary process which allows for success in a market economy. The current Law on insolvency foresees a simple, efficient and flexible management of the insolvency process, with precisely determined deadlines and clearly defined outcomes, division of duties and responsibilities during the process. Besides these, it also foresees the rise out of the crisis for many companies in Serbia which were either 'forgotten' in too long insolvency processes or are too much in debt, and so unable to obtain further loans for new and good ideas which would boost the capacity, make profit and enable to payment of debts. The Law on insolvency defines two options of the insolvency process.

One option is the reorganization in the cases when the recovery of the insolvent company is achievable with a possible refund of a part of the debt and a clear plan of recovery authorized by the creditor. Through reorganization with a new owner the company continues its primary work in accord with the plan and the possibility of write-off of the agreed part of debt, and a clearcut plan for settling the rest of the debt. Reorganization is a crucial novelty of this Law which includes a whole range of possible application of similar methods (closing down unprofitable factories, change of activity, severance and change of conditions in the contract, delay of debt repayment, annuling of debt, conversion of debt, taking new loans and other methods). Other measures can be applied separately or combined, which are not forbidden by law and which are in concordance with the plan and its authorization. By this approach the possibilities for recovery of the debtor were significantly widened, and the possibilities for continuing with the operation increased.

In the other, more drastic case, the option follows, as foreseen by law, i.e. insolvency which helps companies in too much debt which do not have production nor hope for success and recovery in the future, to get rid of the debt and stop further loss. This happens by the sale of property to settle the creditors, while the buildings and machinery will pass to another owner and used for different purposes with the possibility of creating new jobs.

Yet another novelty is represented by the regulation that says that on the day of starting the insolvency process *the workers do not receive notice automatically*, as it was the practice previously, but their fate will be decided later, depending on whether the insolvency process results in reorganization or bankruptcy. Insolvency will play an important part in the privatization process in the cases when capital of a company in debt is privatized, and there is no interested buyer or creditor. Then the insolvency process is initiated so that the company could be made more attractive for successful privatization within the period of up to a year.

Both options of the insolvency process, reorganization and bankruptcy are conceptualized under the new Law with the function of either to keep or create new jobs and strengthen Serbia's economy.

The consequent application of the Law on insolvency enables that instead of subventioning 'black holes', i.e. economic systems too far in debt without visible results, means from the budget (payment of contributions and taxes of the citizens of Serbia) can be directed through developmental loans for the furthering and future success of small and medium-sized companies which will make profit and create new jobs. It would be useful to make use of the positive experiences of the application of various privatization models in other countries in transition.

Conclusion

By critically analyzing this process under the specific circumstances of this country, one has to state that property transformation happens significantly slower and in different forms compared with other countries. The privatization which began at the end of the 1980s was regulated by law in the sense that the state enabled the alternative of privatization itself, but not only the right to choose the model, but also the autonomy to decide when and how they would carry out the privatization. In fact, companies conducted privatization autonomously. This slowed property transformation down and led to further decline of social capital. In the beginning the decisions were brought by the self-governmental structures of the companies (primarily the workers' committees with the approval of the syndicate) in agreement with and influenced by the bureaucratic control and management structures. In the later period the right of decision was left to the management of the company which made decisions about privatization consulting the workers' syndicates as well, though mostly heavily influenced by political and party factors and local self-government bodies. According to the new legislation, companies which missed the chance of privatization do not have the right of making decisions anymore. Currently the state decides when a company will be privatized, and if via public tender, auctioning or possibly restructuring. Thus, the company is not longer the subject but the object of privatization.

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