

# SOEs in Serbia: Substituting Market Failure with Government Failure



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instances, interference takes the form of state-owned enterprises (SOEs) that produce goods or provide services instead of private companies. However, what is often overlooked is the fact that market failure can be exchanged for government failure, in which total welfare is not increased by government actions, and sometimes is decreased by it. The reasons for this can

be numerous: from lack of knowledge, incompetent administration, and political cycles, to corruption and state capture<sup>1</sup>.

In Serbia there is a plethora of possible government policy actions beyond the establishment and operation of SOEs. Having in mind the negative results stemming from the operation of SOEs, to alleviate this problem an approach other than appointing new management is necessary, as might be heard in public discourse.

Serbian SOEs are poorly managed and are used as tools for keeping social peace with unreasonably low prices of services rendered, high wage bills, and low efficiency. SOEs also pose a high fiscal burden (relying on high government subsidies) and fiscal risk (their debt is often taken over by the government due to liquidity or solvency issues).

### **SOEs IN THE SERBIAN ECONOMY**

SOEs have a prominent role in the Serbia economy, employing about 10% of all registered workers. The total number of SOEs is not publicly disclosed, as there are different methodologies in deciding which companies should be included in the list. Therefore, the data regarding their operations – although coming from formal government sources – should be taken with a grain of salt, since some of them are contradictory.

Serbian SOEs can be subdivided into several categories:

#### **1. Public enterprises**

Two government bodies that supervise the work of public enterprises provide two different figures for these companies. The

<sup>1</sup> Tullock, G. et al. (2002) *Government Failure: A Primer in Public Choice*, Cato Institute.

Ministry of Economy listed only 37 companies as public enterprises on their website, while the Commissioner for Information of Public Importance and Personal Data Protection listed 137 of them<sup>2</sup>. They employ about 79,000 people<sup>3</sup>. The companies have a special status because they are considered vital to the economy or welfare of the population. As such, they must render their service at all costs and cannot go bankrupt because the government must see to it that the service be provided in continuity<sup>4</sup>. The status of a public company is granted by government via by a special sublegislative document; these by companies can function in the form of a limited liability company or a public limited company. However, their shares cannot be traded and their proprietor is the state itself. The Ministry of Economy appoints the managing boards and CEOs in a process that is envisaged to be transparent, but is prone to political pressures. The companies are concentrated in several industries, such as power generation and distribution, natural gas distribution, postal service, national parks, real estate, and rail transport.

## 2. Municipal enterprises

This group includes about 350 enterprises that operate on the local level and were set up by local governments (cities, towns, and

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<sup>2</sup> The Ministry of Economy uses the legal definition, stating that public enterprises are companies that “provide service of general importance” (Law on Public Enterprises, Official Gazette 15/2016). The Commissioner for Information of Public Importance in its catalog lists all legal entities that were set up or that are being financed fully or predominantly, by the central government (Law on free access to information of public importance, Official Gazette 120/2004, 54/2007, 104/2009, 36/2010); the majority of these companies are actually public enterprises since only they are directly financed by the government. The two lists, therefore, overlap.

<sup>3</sup> Ministry of Finance of the Republic of Serbia (2016), *Fiscal Strategy for 2017*.

<sup>4</sup> Law on Public Enterprises, Official Gazette 15/2016, article 14.

municipalities). They are mostly active in public utilities such as district heating, water supply, and sewage, and employ 67,000 people<sup>5</sup>. Their management is appointed by the local government and their status corresponds to that of central government public enterprises.

## 3. SOEs

These companies are owned by the government, but they do not have the status of public enterprises. Therefore, they operate in the open market with competition from private companies and are limited liability companies. Some of the companies have shares that are freely traded on the stock market (Nikola Tesla airport, oil company NIS) while some of them, although listed, cannot be traded (telecommunication company Telekom Srbija). Their number is not discernible because they operate as any other company, though their management is appointed by a board of directors, which is in turn appointed by the shareholders (a line ministry in cases where government is the majority owner).

Not all companies are completely owned by the government; some have minority shareholders, and the state may be a minority stakeholder in some cases.

For example, Telekom Srbija (the national telecommunication company) has a small number of shares owned by employees and the general public that were administered through a voucher scheme, but the majority is in the hands of the government. The NIS (national oil company) has been privatized to the Gazprom Neft company, but the state has retained a 49% minority share, as in the case of Air Serbia, the national airline company.

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<sup>5</sup> Fiscal Council (2017) *Local Public Finances: Problems, Risks and Recommendations*.



WHEN  
GOVERNMENT  
EMPLOYEES  
(ADMINISTRATION  
AND SERVICES SUCH  
AS EDUCATION  
AND HEALTH CARE)  
ARE TAKEN  
INTO ACCOUNT,  
SOEs ACTUALLY  
EMPLOY ALMOST 15%  
OF THE WORKFORCE  
THAT IS ACTIVE  
IN COMPANIES  
THAT OPERATE  
ON THE MARKET

State companies are prominent in many sectors, such as furniture manufacturing, pharmaceuticals, mining, telecommunications, and chemicals.

#### **4. Companies in restructuring and social ownership**

This group is something so peculiar that it can be found only in Serbia and former Yugoslav countries. Prior to the privatization process, a majority of companies were in "social ownership", which was a brand

of self-governing socialism present in socialist Yugoslavia. During transition, the companies should have had their ownership status changed, from social to state (through new registration) or private ownership (through privatization).

The process of ownership transformation and privatization commenced with the Laws on Social Capital (1989), Law on Conditions and Procedures to Transform Collective Property into Other Forms of Property (1991), and Privatization Law (1997), which all advocated insider privatization, culminating in the Law on Privatization (2001), which stipulated majority capital sales through tenders and auctions<sup>6</sup>.

However, since many of those that were privatized through the selling of capital were later in a legal vacuum since its privatization contracts were terminated (usually because the buyers did not honor their part of the deal, such as paying the full price when paid in installments), they reverted to their previous legal status. Usually, they were in a bad situation and soon entered bankruptcy, which was prolonged to provide a safety net for the workers<sup>7</sup> while their wages were paid through state loans or direct subsidies.

In 2016, there were 220 such companies with 45,000 workers<sup>8</sup>.

That shows that the total level of involvement of the state in the market is quite substantial, with about 190,000 employees working in SOEs of different types in various industries, 10% of the total number of

<sup>6</sup> Vujacic, I. et al. (2016) *Privatization in Serbia - an assessment before the last round*.

<sup>7</sup> Some companies spent almost a decade in this bankruptcy limbo, which basically annulled the property rights of their creditors.

<sup>8</sup> Fiscal Council (2016), *Fiscal Trends in 2016, Consolidation and Reforms 2016 - 2020*.

all people employed (1.9 million). However, when government employees (administration and services such as education and health care) are taken into account, SOEs actually employ almost 15% of the workforce that is active in companies that operate on the market.

### MANAGEMENT: COMPETENT OR POLITICAL?

The large sector of SOEs, whose role is more prominent than in a majority of other European countries, is a legacy of the socialist economic and political system, and voter preferences.

However, SOEs in Serbia can also be used for political and economic benefits. The political benefits could be in the form of buying popular support (among voters whose preferences are state involvement in the economy or among those employed in the companies), while the economic ones could be embezzlement or corruption, for private or party purposes. SOEs are often regarded as feudal domains, and their "allocation" to parties in coalition government is unofficially considered an important part of every coalition agreement<sup>9</sup>.

One of the surest ways to exploit their operation by political parties is to appoint management liable to pressure from the executive government. That is relatively easy, as the Law on Public Enterprises stipulates that the government appoints the CEOs of these companies, as well as all members of the governing board.

Although there are some legal requirements that were envisaged to disable political pressure<sup>10</sup>, they all are easily cir-

cumvented. In several cases, CEOs are high-ranking party officials (as in the cases of Galenika [pharmaceuticals], Srbijagas [natural gas transport and distribution], and until recently the Post Office) or people who are not party members but have close personal connections to members of government (electrodistribution company EMS is managed by Nikola Petrovic, who was allegedly the best man in the wedding of the previous prime minister and current president, Aleksandar Vucic).



## POLITICAL PARTIES USE MANAGEMENT POSITIONS IN SOEs AS LUCRATIVE SINECURES FOR LOYAL PARTY OFFICIALS

The issue of education qualification is circumvented through corruption in higher education: Party officials have been known not only to buy university diplomas, but also doctorates or even secondary school diplomas when they only have an elementary education. The cases of the former

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employees and one is an independent (not a member of a political party); a CEO should resign his position in the party which he belongs to; and there are some provisions regarding the level of education or professional experience of CEOs and that they should be appointed after a public call (Law on Public Enterprises, Official Gazette 15/2016).

<sup>9</sup> Due to the Serbian election system, coalition governments have been a constant factor of political life in the country (all government since the democratization in 2000 were coalition governments).

<sup>10</sup> One member of the board is a representative of em-

Table 1: Non-public<sup>11</sup> vs. public company performance (in billion EUR)

2015	Non-public companies	Public companies
<b>Total Assets</b>	105.5	15.6
<b>Equity</b>	49.5	12.9
<b>Net financial result</b>	1.2	0.1
<b>Return on Assets</b>	1.12%	0.44%
<b>Return on Equity</b>	2.37%	0.53%

Source: Serbian Business Register Agency of the Republic of Serbia, *Financial Statements Annual Bulletin for 2015*, Belgrade, 2016

President Tomislav Nikolic, Belgrade Mayor Sinisa Mali, Minister of the Interior Nebojša Stefanović, and State Secretary in the Ministry of Foreign Affairs Ivica Toncev, among others, are only the most publicly exposed cases.

Apart from those illegal tools to circumvent the Law on Public Enterprises, there are instances when the law is completely disregarded, the best example being the public call for new management. The new law adopted in 2016 stipulated that new management had to be appointed using the new transparent procedure (using a public call, after which a commission composed of members of parliament and state bodies would create a ranking list, where the highest ranking candidate would be appointed CEO) within 12 months or March 2017 at the latest. However, when that schedule had passed, most public calls have not even been published, let alone CEOs appointed.<sup>12</sup>

<sup>11</sup> Non-public companies include private companies as well as state-owned companies that do not have legal status of public enterprises.

<sup>12</sup> Transpareny Serbia (2017) Late calls for public enterprises CEOs. <http://www.transparentnost.org.rs/index.php/sr/aktivnosti-2/naslovna/9062-sporni-i-zakasneli-konkursi-za-direktore-javnih-preduzeća>

The current situation in this field shows that political parties use management positions in SOEs as lucrative sinecures for loyal party officials. The loyalty goes both ways: Even if an SOE shows bad business results, the CEO and members of the managing boards would not be dismissed. For example, for almost a decade the CEO of Srbijagas has been Dusan Bajatovic (Socialist Party of Serbia), and during this time the company incurred losses so high that it has lost all of its capital, and transferred more than EUR 2 billion of company debt (equaling almost 7% of GDP) to the government, which is almost 10% of the total government debt. Bajatovic, of course, still operates the company.

Since SOE managers know that their positions are safe only as long as they are loyal party soldiers, and that their results are not crucial, they lack incentives to achieve good business results. Furthermore, the situation is further jeopardized by political corruption. A party takes control of an SOE through the management, which then has to fulfill governing party requirements, such as providing lucrative posts to other party officials and ordinary party members<sup>13</sup>.

<sup>13</sup> High unemployment of 14%, low job security, and

Table 2: The performance of two biggest telecommunication companies in Serbia (in million EUR)

2016	Telenor Ltd.	Telekom Srbija
Total Assets	405.4	1 590.5
Equity	279.6	1 088.8
Net financial result	73.2	125.0
Return on Assets	18.05%	7.86%
Return on Equity	26.18%	11.48%

Source: Financial statements of respective companies

Another issue regarding public procurements by SOEs, and the corruption stemming from it, are several recent scandals<sup>14</sup> that are still waiting on litigation due to the inactivity of public prosecutors. Although it is hard to claim that corruption in public procurements is only caused by political party involvement, the situation significantly boosts this phenomenon, providing an environment in which corruption by party officials remains unpunished, if not openly encouraged.

### INEFFICIENCY, INEFFICIENCY EVERYWHERE!

Although some SOEs operate with high revenues and profit (mostly the national telecommunication company Telekom and the energy company EPS), most of them operate with losses. That can be illustrated with data from the financial registry, which compares the data from financial statements of 485 public companies with the rest of the economy [See Table 1].

It is evident that public companies, overall, are less efficient than private companies. Although 2015 was a good period for pub-

lic companies because they finally stopped incurring losses, they operate with low profitability. Private sector RoA and RoE are 2.5 and 4.5 times higher, respectively. Inefficiency is also evident in the case of the most profitable SOE, Telekom Srbija, with RoA and RoE approximately 2.5 times lower than that of its main market competitor, Telenor Ltd. [See Table 2].

The causes of inefficiency in SOE operations are found in political appointments to their management. However, the problem is not that board members or CEOs do not possess adequate knowledge (they could always employ experts who could advise them on how to run the company). Instead, the main problem with political appointments lies in the above-mentioned fact that management obeys party headquarters to use SOE resources for political purposes – to stay in power and gain more votes in the next election. That is mostly done by SOEs taking over some elements of social policy through prices and employment.

### REALIZING SOCIAL POLICY THROUGH SOEs: PRICES

In the best-case scenario, SOEs should function on the basis of business revenues only. The revenues ought to be high enough to cover all expenses and pro-

lower salaries in the private sector serve as good incentives to seek employment in the public sector, which can be obtained through party membership.

<sup>14</sup> For example, rigged tenders for public bus transport in the City of Nis, construction of the railway station Prokop in Belgrade.

Table 3: Electricity prices in Europe

Country	Cents per KWh
Serbia	0.065
Albania	0.082
Bosnia and Herzegovina	0.083
Macedonia	0.084
Montenegro	0.099
Hungary	0.115
Czech Republic	0.129
Romania	0.132
Croatia	0.131
Poland	0.142
Germany	0.295
Denmark	0.304

Source: Eurostat, *Energy price statistics*, available at: [http://ec.europa.eu/eurostat/statistics-explained/index.php/Energy\\_price\\_statistics](http://ec.europa.eu/eurostat/statistics-explained/index.php/Energy_price_statistics)

Table 4: Utility water prices in Europe

Country	USD per cubic meter
Albania	0.53
Serbia	0.53
Macedonia	0.54
Bosnia and Herzegovina	0.88
Romania	0.90
Bulgaria	1.06
Montenegro	1.12
Slovakia	1.32
Poland	1.39
Czech Republic	1.67
Croatia	2.16

Source: IB Net (International Benchmarking) database, available at: <http://database.ib-net.org/DefaultNew.aspx>



Table 5: Number of staff in water utilities in Europe

Country	Per 1,000 population served
Slovakia	0.04
Czech Republic	0.29
Germany	0.32
Denmark	0.35
Poland	0.4
Hungary	0.92
Croatia	0.97
Serbia	0.99
Macedonia	1.08
Bosnia and Herzegovina	1.47
Bulgaria	1.74
Romania	2
Albania	2.02
Montenegro	4.44

Source: IB Net (International Benchmarking) database, available at: <http://database.ib-net.org/DefaultNew.aspx>

vide for long-term capital investments in infrastructure, especially in utilities. The price policy needs to be efficient; prices shall be defined in such a way as to cover full costs. However, in this manner, state-owned companies would need to set prices that would be much higher than they are today.

Populism through prices for SOE services has a strong legacy from socialist times because the regime tried to make at least some basic utilities affordable for all citizens. It started to be used more frequently during the chaos following the dissolution of Yugoslavia and the economic and social crisis that followed (GDP in Serbia plummeted to less than half of its 1989 level, international sanctions on trade were imposed, and there was one of the highest hyperinflations in the world in 1993). Unfortunately, populism through prices is used to this day. It can be illustrated through comparing household electricity prices (including taxes and levies) among countries in Europe [See Table 3].



DUE TO THEIR INEFFICIENT OPERATIONS, MANY SOES IN SERBIA HAVE TO RELY ON DIRECT OR INDIRECT STATE AID

It is understandable that Serbia has electricity prices lower than more-advanced European countries because of the higher standard of living enabling their citizens to afford higher prices, and also because of the higher share of renewables in electricity generation, among other reasons.

However, Serbia has much lower prices in comparison even with countries on the same level of economic development measured by GDP per capita such as Montenegro, Macedonia, Bosnia, or Albania. The same trend is visible in water supply and sewage [See Table 4].

### REALIZING SOCIAL POLICY THROUGH SOE: OVEREMPLOYMENT

SOEs are used not only for political sinecures, but also to boost total employment in the economy, providing jobs for thousands of people who would otherwise remain unemployed, especially in areas outside of the bigger cities. That can be illustrated by employment figures from financial reports for SOEs that are active in industries where there is no single provider, so their data can be compared to their competition.

Data show that the national telecommunications company, Telekom Srbija, employs eight times more people (8,203 employees in 2016) than its main competitor Telenor (1,033 employees in 2016). Since these two companies are active in the same market and have similar strategies (main income coming from mobile telecommunications, high investments in internet provision, and new ventures in mobile banking) overemployment in the state company is obvious.

For utility sector SOEs that have monopoly status, such comparison is not possible. However, it is possible to compare Serbian utilities with those from other countries. The data show that Serbia is somewhere in the middle of transition countries by the indicator of the

Table 6: Subsidies in Europe

Country	Subsidies in % of GDP
Poland	0.5
Romania	0.5
Slovakia	0.6
European Union	1.3
Hungary	1.3
Euroarea (19)	1.5
Bulgaria	1.8
Croatia	1.8
Czech Republic	2.3
Serbia	2.9

Source: Eurostat, Government Finance Statistics, available at: [http://ec.europa.eu/eurostat/statistics-explained/index.php/Government\\_finance\\_statistics](http://ec.europa.eu/eurostat/statistics-explained/index.php/Government_finance_statistics) and Consolidated Public Finance Report of Ministry of Finance (for Serbia)



SOME SOEs ARE LEGAL MONOPOLIES AND, THEREFORE, DO NOT FACE COMPETITION IN THE MARKET BUT STILL USE LAVISH SUMS OF MONEY FOR ADVERTISING, REGARDLESS OF THE FACT THAT THIS WILL NOT INCREASE THEIR SALES

number of employees per 1,000 population served by water utilities. However, there are several countries where water utility companies are much more efficient within this group – Poland and the Czech Republic have two or three times less staff, in line with the countries from Western Europe [See Table 5].

Several companies could be used to illustrate this overemployment phenomenon. For example, business revenue of the Resavica mining company cannot even cover its wage bill expenses, so the company relies heavily on government subsidies. IKL Jagodina, a company active in the cable production industry, has a peculiar and unsustainable employee structure: Of 1,200 employees, only 400 work directly in production while 800 are administrative workers<sup>15</sup>.

#### **FISCAL CONSEQUENCES OF INEFFICIENT SOE OPERATIONS**

Due to their inefficient operations, many SOEs in Serbia have to rely on direct or indirect state aid. The direct state aid goes through subsidies that are paid on an annual basis and are visible in the state budget. The biggest share of these subsidies goes to the railway transport company Zeleznice Srbije (almost EUR 100 million every year). However, indirect costs are also substantial, but almost impossible to calculate.

Indirect costs can be classified as tolerated arrears for taxes (in some cases SOEs are among the biggest tax debtors) and utility services (one SOE does not pay its bills for water, heating, or electricity to another SOE). The Government Development Fund often provides liquidity or investment loans with preferential interest rates which are seldom paid back. The Development Fund usually takes part in equity share, which is

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<sup>15</sup> Fiscal Council (2016) Fiscal Trends in 2016, *Consolidation and Reforms 2016–2020*.

just an accounting trick since the government is the owner of both entities, so the ownership structure does not change at all.

Therefore, state subsidies in Serbia are much higher than in EU countries or other countries in transition, reaching almost 3% of GDP [See Table 6]. However, those are only direct subsidies, the cash amount paid. The amount does not include indirect supplements, such as paying off SOE state-guaranteed debts, providing loans with preferential rates, resources from discretionary budget reserves, arrears in paying taxes, and forgone profits — a sum that was estimated by the World Bank mission in 2013 to be around EUR 700 million or 2% of GDP [See Table 6].

### **SOEs AS ENEMIES OF MEDIA FREEDOM**

SOE operations in Serbia are detrimental to media pluralism and freedom as well. Political influence over the media is exercised through marketing and SOE advertising, as evidenced by the report of the Anticorruption Council, an independent state body<sup>16</sup>.

In a nutshell, SOE management does not advertise its products or services in the media that are critical toward the government. Furthermore, some SOEs are legal monopolies and, therefore, do not face competition in the market but still use lavish sums of money for advertising, regardless of the fact that this will not increase their sales. That is because their expenses are used as some kind of pecuniary reward for media silence. Another issue is the lavish costs of marketing and PR activities of companies undergoing restructuring. Since they basically survive through direct and indirect government subsidies, the expenses are dubi-

ous in nature, especially because they go through companies connected by high-ranking political officials (as was the case of Prva petoletka, a TV station that is owned by the wife of Minister of Defense Bratislav Gasic).

All that leads to the situation in which the media do not hold politicians accountable because a large part of their income is derived from SOEs controlled by the same politicians.

### **CONCLUSIONS**

The SOE sector in Serbia is bloated with an oversized staff, inefficient price policy, and controlled by political parties. That causes mismanagement and corruption, leading to inefficient economic outcomes. Therefore, SOEs pose a high fiscal burden of at least 3% GDP directly, and possibly another 2% of GDP through indirect means<sup>17</sup>.

All the characteristics of Serbian SOEs prove the claim that possible market failures are supplanted by certain government failures.

To improve the level of services rendered to the public, bold steps in SOE privatization must be taken. Raising capital investment, and thus the quality of infrastructure, and alleviating a heavy fiscal burden stemming from inefficient operations cannot be done in the current system. As some advanced countries prove, providing professional management for SOEs is possible, but necessary preconditions for this development, such as strong and effective public institutions, political accountability, and rule of law, must exist. Serbia, as a country with a high level of corruption, low government efficiency

<sup>16</sup> Anticorruption Council (2015), *Report on the possible influence of public sector institutions on media through marketing and advertising services*.

<sup>17</sup> World Bank, *Republic of Serbia: Municipal Public Finance Review - Options for Efficiency Gains*, 2014.

and political accountability, and a weak rule of law, provides an environment in which government failure is almost an inevitability. It would take decades, if not generations, to build the necessary preconditions to prevent, or at least lessen, government failure in managing SOEs.

Therefore, the only viable solution for an increase in efficiency of SOEs is including the profit motive by their partial or full privatization<sup>18</sup>. That does not necessarily mean no government involvement, as price regulation in certain markets considered to be natural monopolies is still possible, in accordance with EU rules. But such government intervention is much different than setting up and operating a company, leaving much less room for political influence, corruption, and a negative economic impact on society.

## POLICY RECOMMENDATIONS

Although the privatization process in Serbia has been plagued with a plethora of misconduct and numerous corruption allegations, privatization is the only short-term way to eliminate political parties from managing SOEs. That alleviates the fiscal burden stemming from high subsidies, and also increases future public revenues through increased efficiency and productivity. Furthermore, the policy would have economic and political consequences because it will provide less room for political clientelism, corruption, and media influence. Thus, the following measures are recommended:

1. Full privatization of all SOEs that operate in competitive markets: Telekom, Galenika, EPS.

2. Liberalization of market segments that are still under monopoly by SOEs (for example, postal traffic).

3. Minority or majority equity privatization of companies operating in market labelled as natural monopolies.

4. Total privatization of the rest of the companies in restructuring. Bankruptcy and closing down of those that cannot be privatized for a lack of interested buyers. ●



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<sup>18</sup> Privatization Agency of the Republic of Serbia, *Impact Assessment of Privatization in Serbia*, 2005.

