

# THE QUESTIONABLE ACHIEVEMENTS OF CORPORATE GOVERNANCE: case of Serbia

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## Abstract

What we can say about particular features of corporate governance we have already experienced? Precisely, was it influenced by our general transition achievements, privatization methods or the range and size of privatization?

In the case of Serbia, facts suggest that there was existed a significant delay in the process of privatization, whereas a certain changes were made in the area of corporate governance.

According to careful assessment of corporate governance, surprisingly, we happened to have been recognized as belonging in some aspects to fair to middling group.

However, in other respect, results are rather modest, due to no suitable institutional infrastructure (i.e. the process of institution building is still far from being finished). Obviously, the structural reform status depends on both relevant legal framework, as well as the institutional environment in which those rules are applied and enforced.

That is why this paper is going to survey our transition path, emphasizing that even in the short term we made some positive movements referring to corporate governance, in the long term they might fade away due to either delays or shortcomings of overall transformation in the economy.

**Key words:** corporate governance, privatization, transition

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## 1. Introduction

Corporate governance is nowadays (especially during last decade) some of the most frequently cited keywords, which reflects the fact that researchers with diverse disciplinary background were and still are interested in this field. While it can not be concerned as a relatively new problem of inquiry,<sup>2</sup> rapidly evolving set of literature is provided with materials that afford either theoretical or empirically-based (but, in any case thought-provoking) overview of this broad area.

The concept of corporate governance describes set of legal, institutional, political, cultural and other arrangements determining the way of dividing rights, claims and responsibilities among the agents within a certain corporation (Blair, 1995) or, being analyzed in a broader way, a network of formal and informal relationships “balancing the rights and interests of multiple stakeholders” (Berglof and Claessens, 2004).

The relative importance of different mechanisms of corporate governance is determined by the ownership and control structure of the firm, and the broader environment in which the firm operates, as well. So, external conditions (environment) may support or inhibit the process of creating healthy governance practices at the level of a firm (so-called corporate governance quality).<sup>3</sup> From the other side, reforms of corporate governance may help in the successful divestiture of inefficient type of ownership (Arun, Turner, 2004) and also can stimulate economic efficiency of the firm and encourage better results at the macro level.<sup>4</sup>

This debate was actualized in transition economies due to their urgent need of choosing an adequate privatization model, which, in turn, could create preconditions for efficient governance and enhance restructuring of firms.

The key aim of this paper is to present some interpretations concerning possible connection between speed and methods of privatization process and the achieved level of good corporate governance.

The paper is structured as follows. Sections 2 and 3 offer an analysis of the transition dilemmas (concerning chosen method of privatization) we are still facing with, Section 4 contains a brief overview of some corporate governance achievements (trying to answer why they are to be considered questionable), and section 5 concludes the paper.

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<sup>2</sup> Separation between ownership and control in large public corporations was the main topic of “The Modern Corporation and Private Property” (published in 1932.) written by Berle and Means.

<sup>3</sup> Corporate governance quality can be “measured” by Corporate Governance Score. For the details see: <http://www2.standardandpoors.com/spf/pdf/products/CGSCriteria.pdf>

<sup>4</sup> Empirical results concerning the influence of corporate governance to the growth can be found in: La Porta, Shleifer, (1998). The advantages of good corporate governance are analyzed in: Fremont, Capaul, (2002).

## 2. First ten years of so-called transition

Most of countries of Central and Eastern Europe started their transition in 1989-1990, when (in former Yugoslavia) major package of macroeconomic stabilization was launched out. At the time we had a substantially greater potential for transformation than other countries from the neighborhood.

A usual way of political and economic transition (implementation of the package consisting of liberalization, stabilization and privatization) was much complicated due to disintegrative processes and unfavorable historical events in former Yugoslavia. Precisely, non-economic factors had direct and irreversible effects which negatively influenced economic performance and slowed down transition.

Keeping in mind that there is feed-back from economic growth to speed and level of privatization (Godoy, Stiglitz, p. 18), it was not surprising that destroyed economy (with negative rate of growth comparing to 1989. level the country could not be treated as slower growing one) experienced inadequate political support for further reforms (including privatization).

Apart from those unfavorable circumstances, the possibility of setting privatization in motion and later on determining its speed, almost surely depended on the form of chosen privatization method (direct sale, mass privatization programs and management-employee buy-outs).<sup>5</sup> These choices certainly affected the ownership structure, corporate governance and restructuring process of privatized enterprises (Godoy, Stiglitz, p. 21).

Although the country started with voluntary insider type of privatization (expecting partial privatization to improve efficiency of governance), it turned into informal (illegal) conversion of social into private property (*asset stripping*). The Law on transformation of social property into other forms of ownership was adopted in 1991 and introduced some more severe procedures (shorter repayment period and lower discounts) worsening the terms of privatization. Till 1997 (due to suspension of previously finished privatization processes) transformation activities seemed to be completely broke. Retroactive changes of previous legislation produced re-socialization of privatized capital thus blocking the privatization process.

The next trial (dating from 1997) appeared to be the continuum of decentralized, non-compulsory and insider privatization, left to the discretion of enterprise. Although employees were induced to privatization by considerable discounts offered in time limited period, the achievements of the program were rather modest because it was used only when it was appropriate out of political reasons.

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<sup>5</sup> The survey of privatization methods used in 17 transition countries has been given in: Estrin, 2002, p. 109.

The concept of insider privatization is not desirable either from the standpoint of restructuring or economic efficiency: first of all, by creating enterprises with employees as owners it conserves the structure of old, self-management system; second, it isolates the firm from capital market and causes outsiders' unwillingness to invest (accelerated concentration was put out of action by regulation issuing the selling of 10, 20 or 25% of shares within period of six years, which obviously postponed capital market to be established); it also diminishes owners' interests to control and monitor managers.<sup>6</sup>

This model was not either fair, employees were given free shares, whereas the others were not privileged that way. Both employees and managers had an ambivalent attitude towards the process: the former were keen of getting free shares but, at the same time, afraid of losing their jobs (their rights were collective and non-transferable and therefore limited to the period of employment in the firm); the latter were (in short term) interested in it (they were given a chance to keep their positions), but from long-term point of view they also had to face with the risk of depriving of favorable status. So, solutions offered by the Law neither reestablished confidence of potential shareholders, nor provided incentives for enterprises to enter privatization.

Generally speaking during 1990s each adopted law (whether on federal or republic level) offered extremely favorable conditions primarily to insiders. All of them provided, more or less, a confirmation of the *status quo*, by affirming and reaffirming non-obligatory nature of privatization (the principle of so-called voluntary privatization), "leaving to the enterprises to decide whether, when and to what extent to enter privatization" (Uvalic, p. 3).

Certainly, in that sense Serbia was not an exception from the rule - insider and voucher types of privatization were dominated in transition countries (more often out of political reasons), which had as a consequence dispersed ownership over the firms and negative effects to the quality of corporate governance.<sup>7</sup>

### **3. Restarting transition**

Until late 2000, insider method of privatization was prevailing – shares were subscribed at preferential terms, or distributed free of charge to insiders, who (at the moment of unfavorable economic conditions) owned worthless shares in highly undercapitalized enterprises.

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<sup>6</sup> Mijatovic, B., Privatization of real sector, in: Begovic, Mijatovic, 2005, p. 185. Although managerial and employee ownership will not necessarily have significant adverse effects, quite enough sounds the fact that it automatically raises the problem of ambiguous property rights. See: Uvalic, p. 10-11.

<sup>7</sup> Djankov, S., and P. Murell, (2002), Enterprise Restructuring in Transition: A Quantitative Survey, *Journal of Economic Literature*, no. 2/2002

Even in the year 2000, out of political/ideological and economic reasons, privatization process was continued according to the Law from 1997. It was the last trial of “old” structures to get additional political benefits by privatization of successful enterprises. New authorities were not sure which model (insider, voucher or direct sale) would be appropriate one for the circumstances. After a while they chose a little bit modified model of direct sale, expecting efficiency growth (speaking from the standpoint of firms) and increasing of budget revenues.

So, according to the Law from 2001, the sale of firms has been introduced as the basic privatization model in Serbia. At the same time it means a radical break up with previous models (the change of the core concept of privatization) and a trial to create a new ownership structure (which might become more concentrated one). This can be understood as some kind of *ex post* improvements (by eliminating the social ownership) meant to facilitate the creation of such ownership structure which turned to be catalyst for good corporate governance.<sup>8</sup>

Bearing in mind that it was too complicated to restrain managers or owners from selfish activities, a firm was obliged to offer 70% of its (social/state) capital on sale preferably to strategic investors (the intention was to attract strategic investor so that the above-mentioned principal-agent problem could be resolved). The main method was cash-based sales, performed through auctions (meant for smaller firms) and tenders (meant for bigger and better enterprises) which were supposed to bring transparency and unable corruption. The voluntary mechanism was suspended and privatization became time-restricted owing to the fact that Privatization agency got the right to manage selling process in a professional way.

According to the data of official statistics,<sup>9</sup> the most significant change was in the group of private enterprises (owing to raising the number of small firms) and also within the group of socially owned ones (whose number experienced trend of decreasing). Speaking of social enterprises and comparing the percentage of sold firms (as a part of those offered for sale) through different periods of time (before and after 2001) results are rather impressive: it grew from 33 to 72%. So, the abolishment of social property<sup>10</sup> finally was progressing in a successful manner. Followed by the assignment of those firms to concrete owners, this process seemed to create preconditions for implementation of good corporate governance.

From the other side, however, partially carried out and defensive restructuring of the largest state-owned companies, having separated their core and non-core branches, caused the increase of the number of state-owned enterprises. It wasn't for the first time such things occurred. Another step backward has happened earlier, when self-management in the state sector was replaced and these firms become supervised and controlled by the governments and its ministries. So, expansion of state sector has taken place through different “channels”: by

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<sup>8</sup> In that sense, good corporate governance could be considered both as a means and as an objective of the comprehensive strategy of privatization.

<sup>9</sup> Source: Reports of the Republic Office for Informatics and Statistics, Republic of Serbia.

<sup>10</sup> Property rights in socially owned firms were ambiguous, non-individual but divided among three collective agents – employees, the enterprise and the state.

exclusion of certain (strategically important) enterprises from privatization, by transformation from socially owned into public firms (Uvalic, p. 5-6), and even lately by so-called pre-privatization restructuring.

Having concerned privatization methods, we can say that auction sale was predominant (if one compares percentage of firms sold through auctions to the data referring to tenders). But, if we take into account realized revenues as the indicator of privatization results, tenders gained more than a half of total revenues (which was expected – tenders were meant to big enterprises). All those changes have some positive effects noticed at the macroeconomic level (the covering of fiscal deficit) and in the area of corporate governance (especially in large firms bought by strategic partners).<sup>11</sup>

However, some disturbing tendencies have been noticed. The wider and deeper privatization processes became, the worse was the ratio of selling price and book value of enterprise.<sup>12</sup> This trend was also expected: after the pick in 2003., when were privatized firms with good to excellent performances, the process of privatization was slowing down due to less attractiveness of the remained (yet unsold) enterprises. “Fine tuning” in the sphere of corporate governance confirmed the fact that investors voted with their money, so in 2003 the size of FDI inflows was significant, whereas the deficiency arose later on reflecting somehow undermined investors’ belief.<sup>13</sup>

The rhythm of restructuring, even for privatized enterprises (overburden with social program), not to mention state or social ones, was not adequate. Also, there were left some arbitrary elements concerning procedures, and especially criteria for privatization which were determined by Agency for each company separately.<sup>14</sup>

Unfortunately, all those things are another confirmation of the fact that we were not “equipped” to eliminate the main weakness of chosen method: it took much time than voucher type to prepare every enterprise for privatization whereas administrative capacity of the economy could not cope with such a burden.

In spite of the fact that regulations were modified and simplified since then, privatization revenue (covering 1382 enterprises and the period to the end of 2004 inclusive) was rather modest – 1,5 billion euros (and certainly less than expected).<sup>15</sup> Why it had happened? Generally speaking, most of privatized companies used the method of internal or insider privatization, so successful firms

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<sup>11</sup> See: Dragutinovic, R., The Aims and Effects of Privatization in Serbia: Quantitative and Qualitative Analyzes, in: Cerovic, B., 2006, p. 10-14.

<sup>12</sup> Mijatovic, B., Privatization of real sector, in: Begovic, Mijatovic, 2005, p. 199; Dragutinovic, R., The Aims... in: Cerovic, B., 2006, p. 10

<sup>13</sup> The situation by the year 2000 (when stock of inward FDI was less than 1% of the total amount invested in all transition countries) is another confirmation of the above-mentioned attitude. See: Economist Intelligence Unit 2000.

<sup>14</sup> Mijatovic, B., Privatization of real sector, in: Begovic, Mijatovic, 2005, p. 193.

<sup>15</sup> During the year 2006, 233 enterprises were sold, which provided investments of 248, 6 million euros and privatization revenue of 262,2 million euros. See: [www.mfa.gov.yu](http://www.mfa.gov.yu)

(at the time) conducted the process according to the Law on Ownership Transformation (dating from 1997). That is why employees remained the most important group of shareholders, no matter a certain concentration of ownership was noticed (dominated, individual owner is insider as well), they are members of Management and Supervisory Boards (so, strategic role of boards is not clearly distinguished from those of management).

From the other side, however, big (especially state) enterprises were either not privatized or were (and still are) under restructuring; Serbia was not attractive area for investment due to political risk; purchasing power of local actors was not promising, so, even selling process had been postponed (which was neither technically nor politically feasible), the expected revenue wouldn't have been significantly increased.

The overall transition trends reflected to ups and downs of new (private) firm entry – a huge initial increase in the number of small private firms was accompanied (due to worsening political and economic situation) by increasing number of bankruptcies, then it stagnated a couple of years and recovered after 2000. Their slightly better performance comparing to results of firms in other ownership arrangements could be attributed to the fact they were using managerial skills of previous (best performing in social sector) firms. So, they absorbed the resources just in time – at the beginning of the transition (Uvalic, p. 11) and exhibited lower managers' turnover (comparing to any other type of firms). But, although newcomers are expected to be the leading ones in transition economy they do not appear exceedingly strong in terms of productivity growth.<sup>16</sup>

Neither has “new” method of privatization in a great extent influenced values and attitudes of managers, even in privatized enterprises.<sup>17</sup> Generally speaking, despite the importance of value and attitudes, it is often happens that they do not translate directly into actual behavior. Critical (so-called attitude-behavior) gaps between those categories have been classified (Leiserowitz, *et. al.*, 2004) as follows: a) priority of different values and attitudes themselves; b) personal capabilities of the decision-maker (for example, the lack of behavior-specific knowledge); c) external obstacles (the lack of laws and regulations). So, old habits and attitudes of managers could be blamed in some extent for the results these firms achieved. But useful explanation of their performance seeks for another angle of observing. Minority shareholder being surrounded by non-adequate educated, but mighty, manager, looks like almost unprotected.

Accelerated concentration of ownership (although initial ownership structure was highly dispersed) is partly, but not significantly, caused by relative poverty and lack of information of small owners.<sup>18</sup> But, the main reason could be find in

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<sup>16</sup> Cerovic, B., Effects of Privatization on Enterprise Performance and Investment Climate in Serbia, in: Cerovic, B., 2006, p. 28

<sup>17</sup> Janicijevic, N., Impact of Privatization on Managers' Work Related Values, in: Cerovic, B., 2006, p. 283.

<sup>18</sup> Zivkovic, B. and T. Jecmenica, Developments of the Equity Market and Privatization, in: Cerovic, B., 2006, p. 80.

incomplete, inconsistent and mutually conflicting laws which gave the management unlimited power. So, ownership concentration has increased out of another reason: almost unprotected minority shareholder, realizing not to have influence in company policies is eager to sell shares; that is why he became an easy target for major shareholder. Being resistant to required changes, interested group (as a part of powerful political structures) through direct self-dealing benefit from corporate control rent at the expense of all stakeholders.<sup>19</sup> As a result of acceleration of ownership, level of corporate governance quality is relatively low, which, in turn, causes lower GDP growth than it supposed to be.

#### **4. Questionable quality of corporate governance**

Although the practice of corporate governance differs among countries, most of normal, market economies usually apply some elements of clearly differentiated models: Anglo-Saxon or European system. The main characteristics of Anglo-Saxon model are very high dispersion of ownership and limited opportunity for shareholder to influence the management behavior by voting right mechanism.

In accordance with the evolution of corporate concepts,<sup>20</sup> defining corporate governance in a broader way, European (German-Japanese or continental) system refers to publicly responsible corporation (so long-term oriented) with high concentration of ownership, meaning that the individual shareholder through the voting right can significantly influence managers' actions (under the assumption the disclosure of financial accounting information is satisfied).

Which of two distinguished models corporate governance in Serbia corresponds to? And why we decided to speak about the achievements and than put them under the question mark?

First of all, owing to ownership transformation, carried out according to 2001 Law, corporate governance mechanisms changed in a certain extent. Serbia has come a long way in incorporating the basic principles of corporate governance within regulatory framework. According to the evidence from Corporate Governance Sector Assessment Project, it belongs to the group of countries being progressive in establishing a sound corporate governance environment. If we take into considerations OECD principles, it will become obvious that the above-mentioned standards are more or less existing in-the-book, so, we can say that Serbia achieves a certain level of so-called "law extensiveness".<sup>21</sup>

On the other side, we have to keep in mind that effective corporate governance relies not only on relevant legal framework governing it, but also on overall

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<sup>19</sup> Joksimovic, Lj., Self-Dealing Transaction in Serbian Privatization, in: Cerovic, B., 2006, p. 256.

<sup>20</sup> See: Dankova, (2006), p. 44-45.

<sup>21</sup> Pistor, *et. al*, (2000).

enforcement environment in which the regulations are applied.<sup>22</sup> So, although transition countries usually “import” regulations from developed ones, just a few of traditional corporate mechanisms are effective due to the fact that written rules are either not adhered to or followed by an appropriate action. The same goes for Serbia, i.e. paying attention rather to change in laws than institutions (discrepancy between law on-the book and the real state of affairs) or incorrect sticking to the rules proves that we are not good at maintaining the so-called “law effectiveness”. That is why corporate governance mechanisms are yet to be activated in the large majority of enterprises.

Taking into account only privatized companies, with a certain level of accelerated ownership concentration and typical form of agency problem arising due to the existence of information asymmetry between management and minor owners (producing major owner could acquire personal benefits at the expense of minority shareholders) we can easily conclude that corporate governance model in Serbia looks like European system.

However, when you take into consideration the whole economy, things seem quite different. Widely dispersed individuals, being relatively uninformed about the corporation affairs are unable to control the allocation of resources; so, dissatisfaction with managers’ behavior causes sell of shares, declining their prices. As a result, in this system management neither act in accordance with shareholders’ long-term interests (being rather motivated to achieve short-term profits), nor it take care of interests of communities. Bearing in mind the ownership structure in Serbia is still rather diffused (mostly urged by insider model of privatization), its above-mentioned features are reminding of primitive version of Anglo-Saxon model.

General problem concerning corporate governance can be derived from the slowness of transition. Such a considering should take into account the following things: initial conditions (heritage), the speed of implementation of policies (like liberalization and privatization of large and small-scale enterprises), and the state of institutions (governance and enterprise restructuring).<sup>23</sup>

So, out of (at least) two reasons there is no need to remind anyone of good initial conditions we had experienced as former Yugoslavia. First of all, Serbia was not and still isn’t the represent of the above-mentioned country (better example is Slovenia which even at the time had the best preconditions for further development). Second, initial conditions, after so many years from transition beginning, have little effect on growth (Godoy, Stiglitz, p. 16, 22), and their role is obviously disregarded in modern economic literature. Thus, we can serve as an

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<sup>22</sup> Economic literature usually accepts the opinion that relative importance of the latter seems to be higher in transition countries. See: La Porta, *et. al.*, (1998), Berglof, Claessens, (2004), Kaufmann, (2005).

<sup>23</sup> About the essentiality of macroeconomic stabilization for recovery and growth, see: Falcetti, *et.al.*, 2005; the importance of initial political conditions is analyzed in: Dabrowski, Gortat, 2002, whereas the significance of institutional quality is emphasized in: Glaeser, *et.al.*, 2004.

obvious example how the key importance of the starting economic conditions was put under a serious question, their role being limited and decreased over time.<sup>24</sup>

After a decade of pause, Serbia restarted its transition, as a “newcomer” in a certain way. Slow progress in the sphere of privatization and institution building helped to preserve previous rules of game which could not be implemented to (a certain degree) changed circumstances, which created the new distortions. Instead of shortening the period of transitory vacuum and let the reformers to break up accumulated inertia (left from the old system) much faster, slower reform involved the necessity to build some palliative solutions (frequent changes in legislation, arbitrary ways of law implementing) which could help to avoid the above mentioned systemic vacuum.

The transition agenda seems to be too difficult and complicated to be completed in few years even by most radical reformers.<sup>25</sup> As Kaufmann suggested (Kaufmann, *et. al.*, 2005) policymakers are particularly interested in trends in institutional quality – is it improving or worsening over time? According to his results, there was only five to seven percent of countries experienced rapid institutional change, so we concluded that institutional quality was changing more often gradually. Although it could not be taken as the excuse for our slow ups, the facts suggested that even advanced transition economies were not completely prepared to handle those challenges well.

What were the results we achieve during the period of restarted transition? Private sector share in GDP (which reflects both entrepreneurial activity and progress in economy-wide privatization) has risen, and this reflects substantial progress in small-scale privatization. From the standpoint of 15 years later (after the first “transition step” was made), it is obvious that we just seemed to have started a serious full-scale transition to a market economy (making up just a little bit of the time lost during the last decade of XX century). Serbia (in spite of all its efforts) is still belonging to the category of so-called less-advanced reformers, lagging behind other transition countries, which suggests an untapped potential for further private sector growth.

We do not believe that low level of some relevant indicators is a consequence of reforms undertaken but not (yet) reflected in the score (as we are often suggested). It is rather caused by the fact that we did finish easier reforms, and now we are faced with harder ones. The movement from very bad position can be attributed to significant improvements caused by the latest legislative arrangements and changes being inspired with them, as well as terrible restarting base. But, although these short-term achievements can't be neglected, all mentioned troubles keep reminding that we didn't get used to good practice of corporate governance.

Due to incompleteness of the reform process, a cluster of institutions are still not in place (well functioning stock exchange, developed capital markets, laws

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<sup>24</sup> Effects of initial conditions on reforms change more quickly in SEE than in other transition countries (Falcetti, *et. al.*, 2005).

<sup>25</sup> That is why (even the advanced) policy-makers are recommended to push ahead in transition (Falcetti, *et. al.*, 2005).

protecting small shareholders, laws which would impose much stricter rules to business conduct), thus impeding activation of effective mechanisms of corporate governance (Uvalic, 2001, p. 15).

That is why the country is treated as the one which has already moved from its initial level of development, but it is suggested to make an urgent move from its early transition achievement to deeper institutional and structural reforms.

## **5. Concluding remarks**

In spite of promising start with privatization (at the beginning of 1990s when in has been proceeded fast), all further “trials and errors” (use of different methods representing sharp discontinuity with the previous ones) brought us to the situation of considerable delay (the deadline for finishing the process of privatization is prolonged till June 2007; there we are and yet the end is not on the horizon).

Privatization itself is not a magic formula either for creating successful enterprises or for solving the problem of corporate governance. It may help and improve some of their aspects, but even the private firms have weaknesses limiting the quality of corporate governance. Taking into account that ownership dispersion itself can not cause any serious problem (widespread participation is usually encouraged by entrepreneurial spirit), nor do it acceleration of ownership (which is said to be incentive for restructuring), it is worth mentioning that undeveloped financial market and inefficient law system (with inadequate protection of minor shareholders) were the main reasons for the above-mentioned effects. It also confirmed the belief of gradualist approach that privatization without institutional infrastructure would not cause wealth creation (Godoy, Stiglitz, p. 2), not to mention incompletely performed privatization.

In a certain extent we have learnt a lesson referring to best practices in more developed countries, but institutional arrangements which would discipline all agents to follow and stick to the rules, are still missing. If we are not aware of it, we will (“all of a sudden”) realize the old truth: there is no adequate medicine for misdiagnosed “patient”.

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