

PROTECTION OF INVESTORS AS A FACTOR OF COMPETITIVENESS OF ECONOMY - SERBIA VS WESTERN BALKANS COUNTRIES¹

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Abstract

Effective investor protection acts as an incentive to the business environment of a country, contributing to the development of financial markets and improving the competitiveness of the economy as a whole. Investment security and greater inflow of capital into the national economy is largely dependent on the efficiency of corporate regulation and the quality of the institutional environment. A relevant factor in attracting investors by corporate responsible companies is self-regulation and voluntary adoption of good corporate governance practices.

The aim of the paper is to analyze the competitiveness of the Serbian economy and the countries in the region in terms of protecting the rights of investors. In the first part of the paper the authors analyze the protection of investors' rights in Serbia at the macro and micro levels, with special attention to the protection of the rights of minority shareholders. After identifying the key internal and external mechanisms of protection, the paper highlights the problems and challenges facing investors in Serbia. In order to identify the international competitive position of Serbia, in a special part of the paper, a comparative analysis of the level of protection of the rights of investors in the Western Balkans countries has been carried out.

Key words: *investor protection, the competitiveness, Serbian economy, comparative analysis, Western Balkans countries*

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INTRODUCTION

Investment security and inflow of capital into national economy is largely dependent on the quality of institutional environment which consists of all the institutions that create standards, policies and rules of the economic, legal, social and political nature. In addition to regulatory bodies and organizations, institutions are also defined as the formal and informal rules that govern human relations (North, D., 1990). High-quality institutional environment is an important driver of competitiveness of the national economy and a prerequisite for creating a business climate where companies generate contemporary competitiveness strategies. National economy is competitive if it is serviced by the companies that operate in accordance with the relevant legal and moral standards.

High-quality institutional environment acts as an incentive to attract potential investors. An effective legal protection of investors, which, along with the adoption of high-quality legal and professional regulation, also involves its effective application, acts as an incentive to investment and business environment of the country, contributing to the development of financial markets and improving the competitiveness of the economy as a whole. To strengthen the confidence of investors in the corporate sector, it is necessary to affirm the corporate governance and continuous education of managers. Investor rights observed at the corporate level are protected by improving corporate governance, whereby shareholders and managers are the key actors in the implementation of the principles of good corporate governance. A competent management that adheres to the ethical principles when interacting with company stakeholders, makes a positive impact on the investor confidence and in such a way both company and the economy become more competitive. Self-regulation and voluntary adherence to good corporate governance practices is a relevant factor in the process of attracting investors by corporately responsible companies.

MECHANISMS TO PROTECT THE RIGHTS OF INVESTORS

Investors who feel protected enough from negligent and incompetent company management and have confidence in the laws and institutions can begin with the realization of planned investments. Realization of fundamental and other rights of the shareholders primarily depends on the quality of laws regulating company law and capital market. Basic shareholder rights should include the right to secure methods of ownership registration, convey or transfer shares, obtain relevant and material information on the corporation on a timely and regular basis, participate and vote in general shareholder meetings, elect and remove members of the board,

and share in the profits of the corporation (OECD, 2004, p. 33). Protection of investor rights can be provided at a macro and micro level.

The legal system of a country should follow the requirements related to the improvement of investor protection, and thus provide security and protection of the rights of shareholders and other stakeholders in companies at the macro level. Legal protection of investors implies defining the positions of shareholders in the company and in the capital market through the legislation and other regulations. Legislative and legal acts are designed to protect shareholders, if properly regulate jurisdictions and efficiency of the securities commission, the courts and other institutions. Institutions that protect the rights of investors are responsible for the good quality enforcement of regulations and standards, as well for the transparency of relevant information about company. Improving the efficiency of the public and corporate institutions leads to increased confidence of existing and potential investors, thereby improving the efficiency of the economy as a whole.

After numerous financial scandals that have damaged investors' confidence, the countries have implemented additional legislative interventions in the system of financial reporting. Novelties in legal and professional regulations include the adoption of values relating to the professionalism, ethics, transparency and collective responsibility of stakeholders of the company. The adoption of the Public Company Accounting Reform and Investor Protection Act (known as the Sarbanes-Oxley Act-SOA) aims to improve corporate reporting by prescribing strict penalties for frauds, increasing management accountability, imposing additional responsibilities of the audit committee and extending independence of auditors. The main contribution to the SOA is the establishment and regulation of functioning of the Public Company Accounting Oversight Board as a higher body for public supervision of the audit quality of companies whose securities are publicly traded. Innovated relevant EU directives also emphasize the importance of collective accountability of the members of administrative, management and supervisory bodies, as well as the relevance of organizing an effective system of public supervision over auditors and audit firms (Stevanović, N., 2011, p. 234).

Despite regulatory inconsistencies and omissions, by observance of fair business practices and the adoption of ethical codes of conduct, the company management can make decisions that do not compromise the interests of owners of capital, but rather make a positive impact on the company performance and meet the interests of all stakeholders. Company managers are professionally and morally responsible for their actions, decisions and overall business success before investors and other stakeholders, but due to the conflict of interest they may be prone to irresponsible management of capital entrusted by the owners. The differing natures of function performed by management and shareholders, depending on specific characteristics

of corporate legal entities, results in the fact that the managers have a more detailed knowledge of structure of the business and have access to more information as compared to the owners of capital. Great power in the process of management and decision-making, and often a fear of achieving poor business and financial performance, loss of bonuses and weakening of rating, may lead management to the unexpected business moves and decisions that deviate from the requirements of owners of capital (Stevanović, S. and Belopavlović, G., 2011, p. 79).

Often there are situations that company managers make decisions in accordance with professional judgment which allows them to exercise influence on the company performances, and hence on the quality of the presented information. Possibility of selection when classifying, evaluating and presenting information, opens the door for manipulative activities to the management without integrity, misleading the information users and leading them to draw wrong conclusions (Stevanović, S., 2013, p. 32). Inadequate sanctioning of perpetrators of frauds can stimulate the emergence of new manipulations, and hence it is important to insist on intolerance towards managers who were involved in financial frauds and to call on the responsible management of capital entrusted to them by the owners.

Conflict situations caused by the separation of ownership and management can be solved efficiently to some extent by using the high-quality accounting and auditing regulations, effective internal control system, internal and external audits, but also by efficient functioning of the board, and an adequate monitoring of management. External audit and supervision of auditors are important mechanisms for external monitoring of management, but monitoring of management can be carried out through controlling privileges of the management and restricting managerial decisions. The more corporate managers and owners of capital oversee each other and the more they are controlled, it is less likely that conflicts of interest in the business will occur (Van Horne, J. and Wachowicz, J., 2007, p. 5). Partner behavior can be expected from a competent and adequately motivated manager who tends to acquire and protect his own reputation. In addition to monitoring and belief in the integrity of management, there are mechanisms that further enhance investors' confidence in the company's management, such as partial ownership concentration, ability to take over the company due to its poor performance and mismanagement, possibility of initiating legal proceedings against the management in the event of non-compliance with defined duties.

Companies with a small number of majority owners easily resolve the potential conflict of interest with its management, provided that there is a greater possibility for abuse of control over a company to the detriment of minority shareholders. The presence of a controlling shareholder and weaknesses in the legal and regulatory framework may lead to the abuse of other shareholders in the company. Extraction

of direct private benefits, inappropriate related party transactions, systematic bias in business decisions and changes in the capital structure through special issuance of shares favouring the controlling shareholder are the examples of abuse actions in the interest of controlling shareholders. Due to unethical behavior the majority owners may work to detriment of minority shareholders, often in collaboration with management and external auditors.

Dealing with agency problem between majority - minority shareholders involves finding appropriate mechanisms to enable protection of the interests and rights of minority shareholders. A key role in protecting the rights of minority shareholders has a legal system of the country with high-quality and effective application of the regulations. The confidence of minority investors is enhanced when the legal system provides mechanisms for minority shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated (OECD, 2004, p. 40), which in turn implies a fair and efficient functioning of relevant institutions.

A clearly articulated duty of loyalty by board members to the company and to all shareholders is a key to protecting minority shareholders. Countries with a well developed corporate regulation, through mechanisms that protect the rights of minority shareholders, have the additional features of external control of management. The possibility of minority shareholders to require additional audits when in doubt regarding the objectivity of financial statements and auditor's report, results in the improvement of management control and reduction of potential conflicts, both between management - shareholders, and between majority and minority shareholders (Dragašević, M. and Lakićević, M., 2007, p. 234). An adequate influence of minority shareholders on the election of members of the board of directors through cumulative voting or through the right to nominate candidates, vested to the shareholders with a certain share in capital, is a characteristic of good corporate governance practices and should therefore be strived for. The position of minority owners of capital in a company may be further improved by electing representatives of minority shareholders, acquiring the preemptive right on newly issued shares and the rights to convene shareholders' general meeting.

By improving the rights of minority shareholders, it creates an effort to alleviate the problem that may arise due to conflicts of interest between minority and majority shareholders. The establishment of national association for the protection of interests of minority shareholders is a step towards improving their position, because only united they can increase their share in the companies' business plans and enhance protection of their own interests.

PROTECTION OF INVESTORS IN WESTERN BALKANS COUNTRIES

Investors choose to invest in the companies that provide investment security and have an adequate investors' protection through transparency of the relevant information and effective supervision of management. By establishing governance structure which enforces the rights and accountabilities of the board members, management and shareholders, it ensures that all of them work in the best interests of the company and its owners. Good governance structure and governance process that is characterized by fairness, accountability and transparency, improve the system of decision-making and promote the prosperity of the company in the long run. The results of surveys conducted by the partner World Economic Forum - WEF show that Serbia, with scores of 3.8 in 2014 and 3.7 in the last four years, demonstrates that accountability of management towards investors and members of corporate boards is at a low level. Unlike countries where the investors and board members have an effective oversight over the work and decisions of a company's management, the assessments of effectiveness of corporate boards in other Western Balkans countries that were analyzed indicate that the level of management accountability is in a range of 4.1 in Montenegro up to 4.5 in Macedonia.

According to the World Bank methodology, lawyers and other legal professionals evaluate the level of investors' protection in the country through filling out the questionnaires of the International Finance Corporation. The level of investor protection is shown within the Doing Business reports in the form of indexes whose values range on a 0-10 (best) scale. The final value of the sub-indicators is a result of the average value of individual indexes that accompany extent of disclosure, extent of director liability and ease of shareholder suits. The level of investor protection in the Western Balkan countries is shown in table 1.

Table 1. Investor Protection Index, Western Balkans countries, 2013.

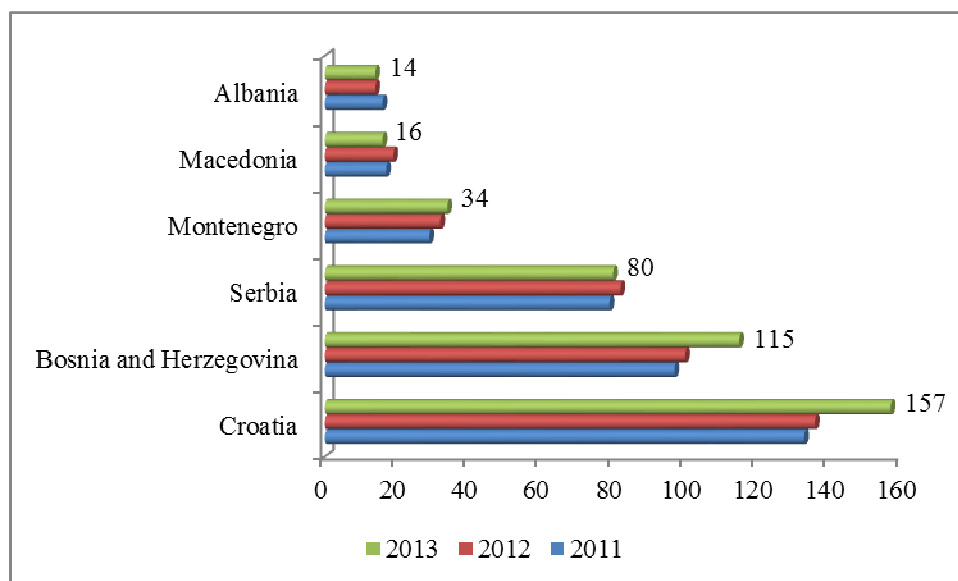
	Albania	Macedonia	Montenegro	Serbia	Bosnia and Herzegovina	Croatia
Protecting investors (rank of 189)	14	16	34	80	115	157
<i>Extent of disclosure</i>	7	9	5	7	3	1
<i>Extent of director liability</i>	9	8	8	6	6	5
<i>Ease of shareholder suits</i>	6	4	6	3	5	4
Strength of investor protection index (0-10)	7,3	7,0	6,3	5,3	4,7	3,3

Source: World Bank: *Doing Business 2014*

The survey results, presented in *Doing Business 2014*, show that investors are best protected in Albania (7.3) and Macedonia (7), followed by Montenegro and Serbia, whose indexes of investor protection are at 6.3 and 5.3 respectively. Index values of the above countries were unchanged in the last three years, in contrast to Bosnia and Herzegovina and Croatia which recorded a decline in protecting investors index in 2013 compared to the previous two years.

Through the analysis of the structure of the average score of investor protection in Serbia, it can be concluded that the highest number of points (7 out of a maximum of 10) was recorded in the area of disclosure of information and transparency. Duties of the board of directors, defined by the provisions of the Companies Law, are monitoring and setting of ethical frameworks for the business operations of a company, as well as providing conditions for disclosure of relevant information and transparency of its operations. One of the ways in which shareholders can enforce their rights is to be able to initiate legal and administrative proceedings against management and board members. Value of index which shows ease of shareholder suits in Serbia is the lowest and stands at 3, while the extent of director liability carrying an index of 6. The level of investor protection in Serbia is better scored than in Bosnia and Herzegovina, especially when it compares with Croatia in which case the World Bank respondents placed the greatest mistrust regarding transparency and disclosure of relevant information about companies. The ranking of Western Balkans countries on the basis of the value of Investor Protection Index is shown in the graph 1.

The relatively high values of the investor protection index, rank Albania and Macedonia among the top 20 countries in the World Bank list in 2013. Serbia's ranking has lowered from 79th position in 2011 out of 183 countries analyzed to 80th position in 2013 when the number of countries participants increased to 189. Non-transparency of the companies is the most responsible factor for the worst ranking of Croatia and Bosnia and Herzegovina, among Western Balkans countries in a three-year reporting period. In addition to the World Bank rankings, the experts from WEF also rank the competitiveness of the national economies in terms of investor protection on the basis of Investor Protection Index, which is shown in the *Doing Business* reports. Analyzing the WEF competitiveness list, Serbia is on a much better position than most other institutional factors. It is the same with other Western Balkans countries, except Croatia. Croatia has extremely low Investor Protection Index, which is lower than the Global Competitiveness Index and the score related to the pillar of competitiveness named Institutions.

Graph 1. Strength of investor protection, ranks of Western Balkans countries

Source: World Bank: *Doing Business*, 2012, 2013, 2014

The results of research conducted in order to analyze and evaluate the competitiveness of the Serbian economy show that surveyed entrepreneurs assess the investor protection on average at the level of 3.29 out of a maximum of 7 points, whereby 60% of respondents score the investor protection in Serbia with 3 and 4 (Djurićin, S. et al., 2013, p. 82).

Shareholders in a country whose corporate governance practice is underdeveloped, may seek protection of their rights in a satisfactory legal regulation. Underdeveloped corporate law, inability to attract professional management, difficult or unsuccessful securing of long-term capital, are only some of the problems that face companies in Serbia. According to the research conducted by the Serbian Chamber of Commerce and the Serbian Association of Managers, the average score of corporate governance relating to joint stock companies is 60.05%. Given that a good corporate governance practice is shown through the final ScoreCard result that is greater than 70%, the average score of 60.05% shows a poor state of corporate practice in the joint stock companies in Serbia. Space from 70% to 100% should be an incentive to the companies for the promotion and implementation of the higher principles of corporate governance.

Mechanisms for the protection of minority shareholders' rights in Serbia are primarily defined by the Companies Law, Capital Market Law and the Law on

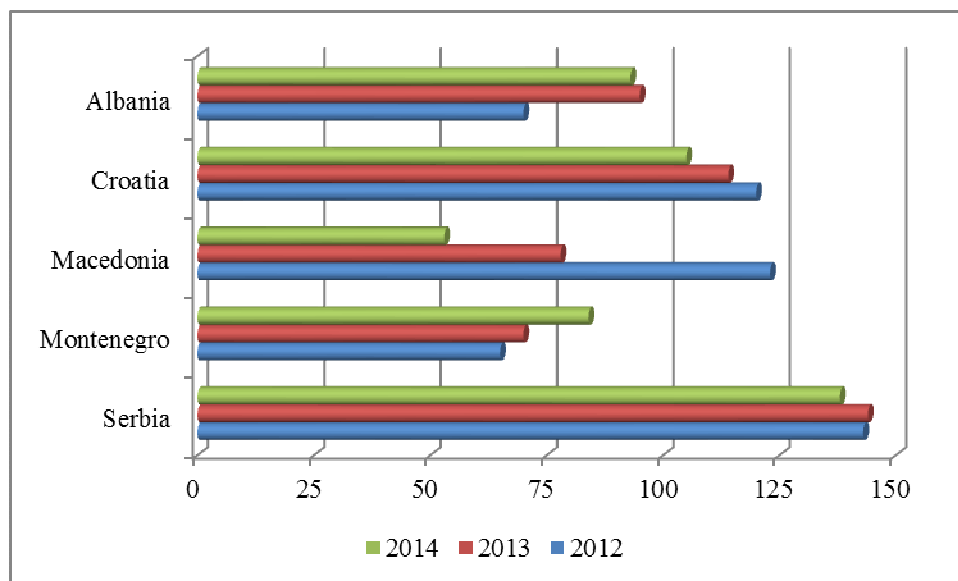
Takeover of Joint Stock Companies. The analysis of these laws, Directive 2007/36, Directive 2004/109 and Directive 2004/25 (Džulić, K. and Kuzman, T., 2012, p. 95) showed that the legislation is fully harmonized with the EU Directives in the field of protection of minority shareholders' rights, and certain provisions are even more detailed and rigorous. A good example is the Capital Market Law, whose main objective is the protection of investors and which sets more stringent requirements in terms of transparency and disclosure of information about public companies with respect to the related EU Directives. After considering regulatory solutions for the protection of shareholders under these laws, we can conclude that a degree of protection of minority shareholders is at a satisfactory level. Having in mind the adoption of the new laws that define the legal framework for the protection of minority shareholders in accordance with the directives of the European Union, it can be said that there is a formal protection in Serbia, but the low level of actual protection of the rights of minority shareholders may be a result of ineffective application of current legal regulations.

Since the voluntary acceptance of obligations and the principles of corporate governance in Serbia is at a minimal level, the minority shareholders can sought their rights in the legal system and relevant institutions. Privatization model carried out through the public auctions or tenders in which the minority packages were purchased in order to create a majority stake and exit from the stock market was not favorable to the shareholders with minority ownership stake in the company. This is confirmed by the fact that the trade in minority packages participated in the total turnover on the stock exchange with only 5-7%, while according to the analysis made by the Privatization Agency (2011), privatized companies with consolidated ownership structure in 2008 accounted for 86% of the total number of companies excluded from the stock exchange. The primary role of the Belgrade Stock Exchange as privatization mechanism, where after the formation of a controlling stake any further trade usually stops, thereby making this aspect of competitiveness even more unsatisfactory (Ristić, B. and Tanasković, S., 2012, p. 75).

The Securities Commission is responsible to organize, undertake and supervise the implementation of measures and sanctions that ensure a lawful, fair, regulated and efficient functioning of the regulated market, in order to prevent disruptions in the market and to protect investors. If minority shareholders believe that their rights have been violated, the role of the courts and the Securities Commission is to ensure the effective protection of ownership rights. Given the fact that Serbia has the lowest value of index for the protection of minority shareholders in 2012 and, according to The Global Competitiveness Report 2014-2015, is placed among the seven lowest-ranked countries, it can be said that the opinion of the Serbian business community is that the interests of minority shareholders are minimally

protected. The scores given by the top managers who were surveyed by the WEF partner in Serbia and other Western Balkans countries indicate the level of confidence of the business community in the quality of legislation and efficiency of relevant institutions in the field of protection of minority shareholders, and the graph 2 shows the competitive positions of the analyzed Western Balkans countries.

Graph 2. Protection of minority shareholders' interests, ranks of Western Balkans countries



Source: WEF: *The Global Competitiveness Report, 2012, 2013, 2014*

Analyzing individual scores given to the protection of interests of minority shareholders, Serbia falls into the group of countries where the rights of minority shareholders are minimally protected. However, in the last three years a positive trend was recorded in terms of assessing the degree of protection of minority shareholders, which is a small improvement of the position held by Serbia in the WEF list. Bosnia and Herzegovina was among the lowest-ranked countries in the Western Balkans in 2012 and 2013, which, due to lack of data, was not included in the latest Global Competitiveness Report. The business community in Macedonia year after year gives better scores to the level of protection of minority shareholders, unlike Montenegro whose rating was getting worse in the observed period. The ranking of Croatia is gradually improving, although the score 3.6 out of a maximum of 7 points remained unchanged in the last three years.

CONCLUSION

An effective investor protection promotes financial market development and competitiveness of the national economy. Quality of the institutional environment in Serbia acts as a disincentive to attract potential investors, because the institutions are not able to ensure sufficiently safe investment and business environment. Weaknesses of institutional factors are reflected in an inefficient legal system, low level of transparency and accountability of public and corporate institutions. High-quality regulation plays a key role in protecting shareholders' rights in Serbia, but further work on its effective implementation and improvement of the legal system has to be done. The adoption of new legislation on companies and capital market has created a good regulatory framework for the protection of shareholders' rights. Effectiveness of the legal mechanisms for protection largely depends on the quality and efficiency of the judicial and other institutions that can provide effective protection to the owners of capital in the event of violation of their rights. A high-quality corporate governance framework should protect the rights of investors, and that is very difficult to achieve in countries with the underdeveloped corporate governance practice.

Institutional environment of the corporate governance in Serbia is characterized by low efficiency of corporate boards and extremely low level of protection of minority shareholders. Comparative analysis of the selected factors of competitiveness in the Western Balkans countries shows that in Serbia the accountability of management to investors and members of corporate boards is at a low level. The more efficient oversight of investors and board members over the work and decisions of the company management was noted in other Western Balkans countries subjected to analysis. The level of confidence of the business community in the quality of legislation and efficiency of relevant institutions in the field of protection of minority shareholders in Serbia is extremely low, placing Serbia among the seven lowest-ranked countries in the WEF list. The business community in Macedonia year after year gives better scores for the level of protection of minority shareholders, the ranking of Croatia is gradually improving, and the ranking of Montenegro was getting worse in the observed period.

The results of research conducted by the experts of the World Bank and International Finance Corporation show that the level of investor protection in Serbia remained unchanged during the last three years, as well as the ranking of Serbia on World Bank list which does not record large fluctuations. Possibility of shareholders to initiate legal and administrative proceedings against management and board members has been evaluated as the lowest parameter of the investor protection index. The lowest value of Ease of shareholder suits Index observed among Western Balkans countries may point to a lack of the effective investor

protection provided by institutions that do not respond adequately in the event of violation of fundamental rights of the investors. Non-transparency of the companies is the main factor responsible for inferior rank of Croatia and Bosnia and Herzegovina among Balkans countries in a three-year reporting period. Improvement of the effective legal protection and corporate governance mechanisms is necessary to strengthen the confidence of investors and business partners, in order to avoid withdrawal or redirection of investments to the economies with more favorable business and investment climate.

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