Shareholding
and Democracy

Milko Štimac

SHAREHOLDING AND DEMOCRACY

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INTRODUCTION

Capital market and democracy

Universal truths should be constantly sought after and re-established, regardless of how axiomatic they might seem. Their apparent obviousness can be seductive and lead to development of an entire theory on something seemingly correct.[1] On the other hand, if a universal truth holds a truly accurate premise, it should be analyzed, described and grasped, to be applied in the study of phenomena of the same kind.

One such universal truth is that there is no free, democratic society without a developed capital market in it and in its economy. Moreover, one can go a step further and claim that there is no developed society without a developed capital market. A short comparative analysis is to prove this.

If it is so, it does not necessarily mean it has to be so, and does not explain why it is so. The first question demanding an answer after the assertion is: Is there a mutually conditional bond between the capital market and democracy?

In order to provide an answer to the question, it is necessary to define the contents of these terms precisely and to state what is meant exactly when one says 'the capital market' and 'democracy'? Moreover, in order to define this, one must deal with higher categories, because if one failed to do so, a methodological error would ensue: Hardly could anything be defined more precisely than by means of using a more

[1] In the introduction of *The General Theory of Employment, Interest and Money* Keynes argues: 'For if ortodox economics is at fault, the error is to be found not in the superstructure, which has been erected with great care for logical consistency, but in a lack of clearness and of generality in the premises.'

general term as a distinguishing characteristic.[2] In this case, it is economy for the ‘capital market’, and when it comes to the term ‘democracy’ it is society or social organization.

At first glance, this does not seem to be a difficult task, but a time-consuming one. From ancient times to the present day, an immense literature seeks to describe and determine the two categories, covering all their aspects. These attempts at interpretation led to the formation of entire schools of thought, most often opposing and excluding one another, and yet all together amalgamated in the single train of the development of social sciences.

Therefore, it is even more surprising that the direct relation between the economic and the societal was observed and expounded much less than the economic or societal phenomena separately. Although it is a universal truth that economy is tied necessarily to a certain societal sphere and that between the two there must be a correlation of a kind, the destiny of obvious, universal truths befell economy as well.

Economy and societal organization have been studied one-sidedly, by simply ignoring the other. If it happened that while studying one, the other got noticed, it was simply to state their different influences, which were to be modified, channeled or even suppressed. For example, in the period of the Enlightenment, discerning the growing importance of trading and the economy in general, Fichte retorted by his work *The Closed Commercial State*, the aim of which was reverting to autarkic economic principles and egalitarianism.[3]

This peculiar imposition of the political discourse on economy has a broad previous background, from Plato and *The Republica*,[4] to Tommaso Campanella and *The City of the Sun*,[5] to Fichte and long afterwards, to the present day. This escape from the essence of association of economy and societal processes, whatever form it took, always implied certain subordination of the economic flows to a higher social aim, as some theorists defined it.

Not until Hayek, was it shown clearly that economic relations

[2] Definitio fiat par genus proximus et differentiam spaecam.

[3] Johann Gottlieb Fichte, *Der Geschlossene Handelsstaat*, published in 1800 (the volume in Serbian: Nolit, Belgrade, 1979)

[4] Πλάτων, *Πολιτεία*, from approximately 380 B.C.

[5] *Civitas Solis*, Idea reipublicae philosophicae, Thomae Campanellae apendix politicae, published in 1623 (the volume in Serbian: Kultura, Belgrade, 1964)

viewed in such a way did not shed light on anything important, but undermined both economy and society.[6] However, on the other hand, before Hayek, and afterwards, theorists who studied economy and the market only seem to have forgotten what economic processes might do to the fabric of society, to disintegration and re-composition of levels of society.[7] There are fresh examples of East-European transition before us and of what has happened in the course of and immediately after the first wave of the contemporary global economic crisis.

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After two millennia of shaping of social sciences, we are at a place from where we can say that still a surprisingly low number of theorists have studied direct links between the economic and the social and their mutual effects, in an ideologically neutral way.[8] Without it, the question asked cannot be answered: Is there a direct, cause-and-effect link between the capital market and the development of democracy?

It is the intention of this work to explore the answer to the question, by placing stone corners. Of course, the first of them must be the environment where economic developments and democratic processes take place, the environment being society itself. Economic activities are linked inevitably to planning and organization. However, this planning and organization should not be grasped as planning on a macroeconomic level, what Hayek dreaded, and what totalitarian systems extolled and applied. Rather, a study of an economic activity considering the micro level, the level of a single activity, entails the recognition of all effects on the activity and the manner in which the effects if adverse should be avoided, or if favorable utilized as much as

[6] 'Just as the democratic statesman who sets out to plan economic life will soon be confronted with the alternative of either assuming dictatorial powers or abandoning his plans, so the totalitarian dictator would soon have to choose between disregard of ordinary moral or failure... the ethics produced by collectivism will be altogether different from the moral ideals that lead to the demand for collectivism.', F. A. Hayek, *The Road to Serfdom*, The University of Chicago Press, 1994, p. 149-150

[7] In the later period of his work, Hayek's views too dovetailed into this.

[8] 'A most unexplored topic... in the literature is the relationship between economic and political institutions', Torben Iversen, *Capitalism and Democracy*, in The Oxford Handbook of Political Economy, Oxford University Press, 2008

possible. This too is planning. Institutions are needed to implement it and organize it properly, to deal with it and recognize the key effects and transfer information to all stakeholders in an economic activity. Such was the case when the guiding institution was the clerical cast of the Old Age countries, who kept an eye on weather conditions and set the time to sow and the time to reap, as it is in a modern society with stock exchanges, chambers of commerce and representative bodies.

At the level of an individual, economic uncertainty might be partially and with a certain success surpassed by broadening experience. However, any complex activity performed over a certain time or season and by several participants requires institutionalization. It can be a spontaneously created Balkan family cooperative headed by an elder or the state as we know it today, which Anthony Giddens argues can be, to a great extent, an instrument of protection, a shield from commercial risk.[9]

*

*   *

Institutions are formed by organization of economy and they transfer the influence of their activities to society as a whole. Decision-makers in institutions strive to protect their positions for continued gratification of their interests. Such striving is satisfied through social bodies, whether they place themselves above others to the level of inviolability, or they laterally link themselves with the decision-makers in social and political institutions. This link is not unidirectional. Both political institutions and decision-makers strive to gratify their own interests in economy. Hence, the interrelatedness of institutions of economy and politics has been a constant feature, since the emergence of organized social communities. They do occur simultaneously, often merging activities, or as in modern times, by interweaving them in mutual, reciprocal conditionality of actions.

The organization indispensable to an economic activity gives birth to a social community with certain ways of decision-making, in other words by forming institutions and procedures within it. The social

[9] Trading, as any other form of economic development always requires an institutional framework, and further on in the text: ‘the state is essentially a risk management system. It is designed to protect against hazards that were once treated as at the disposition of gods’. Anthony Giddens, *Runaway World*, Profile Books, London, 2002 (Serbian issue: Stubovi kulture, Belgrade, 2005 pp. 43 and 50).

community formed in such a way with all the political processes and activities, reciprocally influences economic activities. Sometimes it spurs them, but more often it is a cause of its standstill at a certain level, and therefore its retrogression.

Moreover, concerning the interrelatedness of the political and the economic, tilting the scale in favor of one or the other, leads to the collapse of both. Historically speaking, the systems, organizations of social communities have proven to be the best. They provide that decision-makers in economic and political institutions and the institutions themselves do not blend, because it is always at the expense of one or the other, but to be corrective to each other.

Whatever manner we choose to proceed with examining the interrelatedness of the economic and the social, the social quality of economy must be established first, i.e. the way in which the economy and society interweave and knot.

Once this is established, the definition of fundamental principles and notions which might be common for the economic and social developments should be addressed. Finally, once they are described, it should be seen in which ways they are implemented the best, which institutions shield them and what instruments provide incentives. Undoubtedly, it is the market that occupies the key position among these institutions and within the market, standing most prominently – the capital market.

PART ONE

THE SOCIAL CHARACTER OF ECONOMY

I.1.1. Uncertainty as a cause of social character of economy

The social quality is the key feature of economy. Without society there is no economy. Society, an organized social community, emerges because of economy, because of its organization, erecting itself gradually around economy and developing as much and as economy develops and allows the society to expand and grow.

The social emerges because of and on the basis of efforts to regulate survival of a community, to establish the conditions and rules of such regulation and furthermore, to bring about certain desired effects – preservation and prosperity of the community.[10]

Economic thought from its beginning to the present day has followed the same arc: perceiving the needs of members within a community, what is found in the immediate surroundings to satisfy those needs and the means for gratification of the needs by using what is found at one's disposal. Today too, economy is most often defined, in a somewhat automated way, as an activity of managing resources for the benefit of a certain community.[11] The interrelatedness of the activity and

[10] At the end of the 19th century, professor of the Belgrade University, Mihailo Vujić, simply states in his book that: ’People unite and join together …as it is necessary for economic survival… and further on in the same paragrah: Joining up is therefore a natural and necessary result of the human need to survive economically.’, *Principles of the National Economy*, The Governement Printing House of the Kingdom of Serbia, Belgrade, 1895, (cited according to the Serbian volume: Načela narodne ekonomije, Državna štamparija Kraljevine Srbije, Beograd, 1895, p. 33).

[11] The Wikipedia in English states that Economics is the social science that analyzes the production, distribution, and consumption of goods and services, en.wikipedia.org/wiki/Economics

the community was to wait for the theoretic organization and the modern development of economic thought, with plentiful drifting.[12]

It is noteworthy that it has always been difficult to determine the conditions and the wider, general setting. Any economic activity is linked inevitably to the factor of time and the flow of time, which makes its potential results hardly definable. The setting in which (what we label today as) a social community has emerged is characterized by general uncertainty; hardly any knowledge of the development of future occurrences in which each and every activity of all individuals, members of a community takes its place.

Thus it has remained to the present day. Economy and any other set of human activities remain tied to uncertain results, resulting from the impossibility of the accurate definition of developments and their effects in the future. Economy is firmly tied to the flow of time to developments of processes and activities in time. Moreover, the framework in which its activity is viewed is itself hardly definable, and then only subjectively.

Hence we derive the impossibility of the absolutely accurate and therefore certain expectations of results from the activities carried on today, in a point of time in the future. In this regard, nothing has changed since the time of St. Augustine and his determination of time – the past and the future. According to him, the present is a mere illusion that exists in an infinitely small portion of the past which has disappeared and the future that does not exist as yet.[13]

The answer to such existential uncertainty, regardless of whether it is comprehended meaningfully or grasped only as a general feeling of disquiet, anxiety and uneasiness of being – is organization into communities which regulate conditions for activities ensuring survival. With time, the regulation of conditions brought about attempts to comprehend, to organize meaningfully the setting, the activities in it, and one's place within that setting.

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[12] One example of such drifting away from the main course of economic thought is the concept of economy, viewed in the doctrine of the Orthodox Church, mostly the Greek Church. Economy here is perceived as an act of the Divine pointed in the direction of creation of the world and its subsequent redemption. Manifestly, the focus here is on the relation of the God to the material world, therefore there is no mention of what interests us the most – the relation and interrelatedness between the economic and the social.

[13] St Augustine, *Ispovesti* (*Confessions*), Kultura, Belgrade, 2009

Relatively early, economy in this sense became a subject of meaningful organization. A special skill was singled out as an activity of an organized social community – the answer to the general indefinableness of the setting of activities. Xenophon was the first to name it and the first to define it in the *Oeconomicus*, the Socratic dialogue between Socrates and Critoboulus and Ischomachus.[14] Here, economy is defined as one of the arts and nothing more, just like other arts. It is the business of managing one's own house or estate well.[15] There is still no indication of knowledge of the links between economy and society, its social character as its intrinsic quality.[16]

I.1.2.The art of managing goods

In order to even think about the social character of economy, its implications for all segments of the social and the political even, it was necessary for economy to become accepted as something more than art and to become a science – the path trodden by all areas of human activities in their process of becoming sciences. Pareto says this at the very beginning of his *Manual of the Political Economy*: 'The sciences were arts in the beginning, and little by little they started to study notions independently, striving for completely different goals...'[17] According to Pareto, the goal itself is what differentiated arts from science, as arts are

[14] Ξενοφών, *Οικονομία*

[15] "Economy is 'like the words 'medicine', 'carpentry', 'building', 'mithying', 'metal-working', and so forth, the name of a particular kind of knowledge or science',The Project Gutenberg, E book, Xenophon

[16] Certainly, at first glance it seems that it would be too early to expect a more comprehensive definition of such a complex category in the antique (Greek and Roman) thought, however, often do we get surprised by the debt of the antique thought as if by a rule forgotten in the following periods and then rediscovered. Thus, the *Oeconomicus* by Xenophon surprises us with explanations of other categories and terms such as the capital for example. More of this will ensue further in the text.

[17] '... elles ont été d'abord des arts, mais peu a peu elles se sont mises a étudier les phénoménes indépendamment de tout autre but.', Vilfredo Pareto, *Manuel d'économie politique*, Paris, ed. Marcel Giard, 1927., p. 2.

focused on 'low'[18] activities, and science deals with achieving public welfare, 'as an apostle would do'.[19]

As conditions and relations, the expansion of activities in society, grew more complex, the art of economy also became increasingly complex. Overcoming new obstacles that come along provides incentives to those engaged in science to try to predict the newer and newer obstacles to activities, to contemplate them and search for ways to surmount them directly, practically or cognitively. In this way, an art becomes an increasingly complex skill and then a science, a system of theoretical organization.

One of the great examples for this is facing risk as a constituent element of uncertainty of actions. The naming of the risk itself, as a separate form of uncertainty, its separation as a notion from the general uncertainty of business conditions and being, was a huge step forward. Its separation and differentiation from other terms widened the meaning for economy as well. Economy was shifted in observation and study to the strategic level, and from being an art – it made a leap towards being a science.

The notion of risk as a new and separate notion has been in use from the 16th century onwards. At first, it was mainly used with territorial connotations as 'sailing in uncharted waters. Immediately after, it spread to time, to the future, and this owing to banking and investing. Thus, at least a portion of what was called uncertainty might have morphed into something relatively measurable. Along with the formation of the notion of risk and its transposition from the spatial to the temporal dimension, it was inevitable for the function of computation to develop, the calculation and numerical and (afterwards) tabular and graphical representations of exposure to factors of uncertainty in business at a certain point in the future.[20]

In addition to the numerical approach, an attempt at explaining economic activities which might be generally called technical – emerged in the late 17th century. The Quesnay's *Economic Table*[21] is the best

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[18] 'terre-a-terre', ibid., p.1.

[19] '... comme le ferait un apôtre...', ibid.

[20] Anthony Giddens, *Odbegli svet* (*Runaway World*), Kultura, Belgrade, 2005, p. 47-63

[21] François Quesnay, *Tableau économique*

example of such an approach. Even the name of the school he belongs to – the Physiocratic school – attests to the prevailing technical approach as the term ‘Physiocracy’ is derived from the old Greek language. It is a coined word which stands for ‘Government of Nature’.

I.1.3. From society to economy

Even with Physiocrats, there is no mention of the correlation of a set of activities perceived as economy and its association with society in which these activities are performed. Still, it is the level of theoretical organization, advancement of an art and skill, and not a comprehensive approach which might be considered as science.

No matter how much the foundation of a managed estate is expanded, and therefore what is observed and what is attempted to be explained, a new quality in such explanation is not attained, unless economic activities are comprehended to be more than a manner of organization and regulation of an estate, be it the largest possible, i.e. an entire country.

Even before the Physiocrats, there were attempts to extrapolate the principles of good governance of an estate to the utmost limits, boundaries known to the then world. Thus, for example in the first half of the 17th century, a debate was printed in Prague entitled *Economy of the World in Twenty Chapters*,[22] dealing with the description of natural resources, materials and elements. Good knowledge of elements and resources was to help in management of economic activities. The debate itself, although with a grandiose title, contains no mention of the other.

Finally, the difference between the management of an estate, as it is the meaning contained in the Greek term ‘economy’ (οικονομια), and ‘government of nature’ (φυσιοκρατών) perceived as a large estate is reduced to the volume, not to the essence.

However, the numerical and the technical approach made way for economy as an art to prepare itself for the following step – becoming a science. Instruments were introduced into economic thought, instruments which could objectivize and numerically express the setting

[22] *Oeconomia mundi universi in duodecim tabulas descripta*, Prague, MDCCXXXV

and activities, thereby introducing the higher-level, theoretical approach in the study of economy, shaping all functional links between economic trends and social processes.

However, the deepening of thought regarding economic activities in society could not have waited much longer. At the time of the industrial revolution, at the beginning of its full swing and before the obvious social changes resulting from it, Adam Smith made a key theoretical breakthrough. In the course of one generation, the link between developments in economy and processes in society became so large and obvious that it was impossible to disregard it anymore.

In the introduction of *The Wealth of Nations*, Smith distinguishes two types of people, two types of social communities, and elaborates on their differences. He explains them to be caused by theories encouraging the industry of the country, or those giving rise to the industry of towns.[23] According to him, such differentiation is clearly derived and easy to notice, because it had led to formation of the modern industrial society and, on the other hand, to the development of typically agricultural nations. It is clear and prominent that the social system is responsible for economic advancement or its stagnation.[24] Moreover, Smith unequivocally observes that shaping of public policies has influenced directions of economic development.[25]

While emerging as a science, finally abandoning mere descriptions and calculations fit for an art, economy had the advantage of linking itself to a wider approach studying and explaining the wider base of its causality, development and reciprocal effects on the environment.

Kosta Cukić, professor and Serbian finance minister in mid-19th century, in the introduction of his three-volume book does not depart

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[23] '... The policy of some nations has given extraordinary encouragement to the industry of the country; that of others, to the industry of towns.', *The Wealth of Nations*, Adam Smith, Alfred A. Knopf, New York, London, Toronto, 1991, p. 2

[24] '... Scarce any nation has dealt equally and impartially with every sort of industry. Since the downfall of the Roman Empire, the policy of Europe has been more favorable to arts, manufactures, and commerce, the industry of towns, than to agriculture, the industry of the country.', ibid.

[25] '... Those theories have had a considerable influence, not only upon the opinions of men of learning, but upon the public conduct of princes and sovereign states.', ibid, p. 3

from Xenophon's explanation of the subject of economy, describing it as the science of estate management,[26] the science of acquiring. Further on in the text, he clearly and unequivocally shows that economy develops in the given and created environment, therefore, in an environment which cannot be influenced, referring to the nature and environment, and environment which represents a social system in which economic activities take place. He confirms this with something that could be classified as a behavioral approach to the study of economy. Namely, Cukić divides nations into those which are more entrepreneurial and those which expect the state to make all the arrangements, unlike Adam Smith's categorization of those with prevailing town industries and those where agricultural production, but. Cukić links the entrepreneurship to a government system, and thus characterizes the English and the American people as entrepreneurial. Europe, however, he associates with the system in which it is necessary to go through bureaucratic procedures for any economic activity, while the government is the one that must initiate an economic activity.[27]

Kosta Cukić understands and underscores the importance of social structure and the system of government for attaining the desired economic goals. In his opinion, the influence of the social upon the economic is indubitable to the extent that economic policy should be adapted to particular society.[28] The connection between economy and society is multifarious and most of all – mutual. The influence of social circumstances and the social system to economy was described and studied relatively early, with an aim to reveal and observe a pattern of

[26] '... наукомь газдованя, кућеня...', Kosta P. L. Cukic, *Државна економія*, Belgrade, 1851, I. част (part), p. 11

[27] '... Енглези и Американци су найболъй примъръ ове дълательности самогь народа, кога поэдини грађани несамо да нечекаю савъта и одобреня владе за предузетакь какве корисне раднъ, него нетраже нъне помоћи, уколико неморају ни онда, кадь су за успъхь посла нужни млоги учасници, заэдничко дъланъ, велики капитали, строго придржаванъ правила и дуго чеканъ накнаде. Кадь у тим земляама осниваю приватна друштва изь своій побуда прекоморске телеграфе, желъзнице, читаве вароши и државе, университете и музеє, - тешко се у осталой Европи безь наредбе или барь безь настаяваня и посредованя владе може покои сеоскій путь или болница основати.', Dr. Kosta P. L. Cukic, *Државна економія*, Belgrade, 1862, II, p. 7.

[28] '... Зато се и економно-полицайный задатакь владе у свакой землыи друкчіє мора упражнявати и разумъти.', ibid.

such influence.

Čedomilj Mijatović emphasizes economic occurrences being conditioned by social circumstances even more explicitly than Cukić.[29] One entire chapter of his book is dedicated to social conditions of production development, thus directly linking and explaining the influence of social circumstances to economic development.

Professor Mijatović argues that to have the economy of a nation develop most fully, two social conditions have to be observed – the condition of personal freedom and protection of personal property. When these two conditions are firmly established, they will exert a favorable effect on the economy, stimulating its growth.[30]

I.1.4. Economy as an instrument

Not earlier than the middle of the nineteenth century did the study of the other side of these relations begin, of economy's influence to development of social communities. The influence is multifarious and extends to all segments of society, its strata and all processes in society. To the end of this century, finally a developed approach to economy was in place. The approach did not only concern economy as an art, and it did not single out the influence of the social system on economic circumstances, but also dealt with the effects the organization of economic relations had on the overall social circumstances.

It is almost possible to speak of an axiomatic stand on the issue. At the end of the 19th century, Belgrade professor Mihailo Vujić, without

[29] Prof. Mijatović was a professor of political economy at the Belgrade Great University (Velika škola), subsequently a minister, leader of the Progressive Party (*Napredna stranka*) and an ambassador (to United Kingdom).

[30] Professor Mijatović explains that one of the main reasons for this is that each society and each of the developmental stages did not have all of the social conditions necessary for the production of goods, so that they could fully develop. The conditions being: the right to be liberty and the right to property. Developing, the right to property goes hand in hand with the development of the right of liberty. The ideas are so closely linked that one without the other cannot be even imagined. Čedomilj Mijatović, *The Excerpt from the Political Economics*, The State Printing House, Belgrade, 1867, p. 107 and p. 116

further elaboration argued in his book that the study of economy was the most significant of all social sciences, as the foundation of and a condition for any other activity in a society including political and cultural activities.[31]

Professor Vujić introduced this notion in our country, several decades later than it had started to develop in Western Europe. With the appearance of works of Karl Marx and the powerful influence they had in the course of his working life and immediately after his death, theorists started to avert their attention to examining economy's influence upon social processes and the social system. Marx himself was still persuasive in proving that what happened in economy was a consequence of the political and social system. This point of view provided the foundation for him to formulate his entire theory. Hardly could it be said for Marx that he believed the then democracy to be fundamental or democracy at all. He was persuasive in proving that the proletariat were deprived of any right, economic too, because of a system based on the principles of capitalism and private property.

However, the conclusion derived here made way for an approach that could discern the effects of the economic on the social. Marx did not analyze this. It is clear from his entire work that economic liberation cannot be achieved through economy itself. Quite the contrary, liberation of an entire society must take place in the political and the general social sphere. In his opinion, it is necessary to intervene by a revolutionary overthrow, intervening in the structure of society and to alter the foundation it is resting on, in this case – private property and its protection.

Only then, with a thus liberated production force, devoid of the property of individuals, will it be able to serve to the general welfare of the entire population and thus bring about its liberation in all spheres, from the cultural to the economic. In this manner, it would solve the basic

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[31] 'Economics is the science of highest importance for the social and political life. Since the economic circumstances are the foundations and precondition for any cultural activity, it is obvious that economic issues are priorities when studying and explaining the phenomena of social life. As the development of the entire human society, the destiny of culture and political characteristics can be reduced in essence to economic circumstances and explained by economic causes.', Mihailo Vujić PhD,*The principles of National Economy*, The Kingdom of Serbia Printing House, Belgrade, 1895, p. 13

contradiction of capitalism, which he saw in the fact that the production processes are social, while instruments of production remain in private hands.

Although, he did not consider the possibility that economic relations affect social relations, and that they even change them in certain directions. He was the first to articulate clearly how formulated social activism proceeds from relations established within economy. Hence, the cause is found in economic relations subjected to the political system, so their change can be affected only by changes in the social.[32]

Marx's theoretical theses developed in several directions, none of which diverted from the supremacy of a socially determined higher cause, which then imposed itself upon the entire society and all of its members and their activities. The planning which is instrumental in attaining a better and more efficient organization and distribution is the crux of this theory. Society in it is an abstract sum of members of such society, having uniform needs. Ultimately, it is not composed of individuals,[33] of persons, but of certain social groups: echelons, workers, farmers, educated classes and the like.[34] Economy in this concept is social, inasmuch as it is to be placed in the function of the abstract consumer of goods and services.

From this source onwards, the road led to the complete organization of society and subordination of everything that existed in

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[32] The spirit of activism that characterizes Marx's philosophy was clearly and even essentially formed in the *Theses on Feuerbach*, one of his early works, especially in the eleventh thesis that invites the overall change of everything existing without stopping at the possibility of influencing the social through the economic system. On the contrary, what Marx calls for is the change of the entire world – at once: 'Philosophers have hitherto only interpreted the world in various ways; the point is to change it' – the eleventh thesis states (Die Philosophen haben die Welt nur verschieden interpertiert, es kommt aber darauf an, sie zu verändern.).

[33] 'We do not mean it to be understood from this that... [individuals] cease to be persons; but their personality is conditioned and determined by quite definite class relationships.', Karl Marx and Friedrich Engels, *The German Ideology*, the quote from: *Agency and Mental Models in Heterodox Economics*, Mary V. Wrenn, Journal of Economic Issues, Vol. XL, No. 2 June, 2006

[34] Thus, Karl Kautsky entitled one of his works *The Intellectuals and the Workers* (1903)

society to such organization.[35] What we can call nowadays the Soviet model of organization did not at all acknowledge the independent social function of economy. Economy was reduced to a sum of needs of the population which were to be satisfied. Not only was its impact on the social fabric unnoticed and scientifically ignored, but it would have not been even recognized. The social structure, once established, should have been a constant, in all aspects and on the basis of economy as well.

At the beginning of the twentieth century a current was formed, milder in its methodology for implementation of the theoretical model, to be known as the social democracy, having the clearest theoretical support voiced by the Austromarxism. Here too, the main postulate was not questioned either: The establishment of a larger social goal, planning and determining the road to it and finally implementation of the planned – this was the axiomatic matrix.

The social quality of economy, its equality and interrelatedness with other processes in the society were not recognized. Economy is an instrument comprising a series of activities in production of goods and provision of services, designed for attaining a larger social goal, *id est* – the just distribution. The difference between the Soviet and this theoretical approach is that a person as an individual is recognized but only to accept the planned theses to consciously regulate their productive activity, as Rudolf Hilferding asserts in his major work *Finance Capital*.[36] However, he diverges only slightly from the main matrix of this school of thought, claiming that planning is delegated to a central planning institution.[37]

However, the school has made a step forward towards recognition of at least one component of the social quality of economy, be it in a very limited form. In Rudolf Hilferding's opinion, the link between economy

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[35] 'Marxist thought argues that an individual cannot be studied apart from the totality in which she is situated; it is impossible to understand the totality from the perspective of the individual as the individual is the product of the totality.', Mary V. Wrenn, *Agency and Mental Models in Heterodox Economics*, Journal of Economic Issues, Vol. XL, No. 2 June, 2006

[36] 'The individual members of such a community consciously regulate their productive activity as members of a productive community.', Rudolf Hilferding, *Finance Capital*, www.marxists.org/archive/hilferding/

[37] 'Their labour process and the distribution of their products are subject to central control.', ibid.

and the social becomes manifest only through exchange, and this only in the model of society which correlates with the one acknowledgeable as the capitalistic. It can be deducted from Hilferding's analysis that the social quality as such does not even exist. Rather, it is the matter of absence of conscience in the organization of society, and what we call society is actually reduced to a sum of mutually independent individuals.[38] These individuals perform certain activities for their own benefit and not for a larger social cause. The only connection between them, what keeps them together in groups, is the fact that the development of the division of labor had led them to specializing in economic activities, incapacitating them to gratify their own needs, which compelled mutual exchange. Exchange is the only component of the social quality of economy which Hilferding acknowledges and this only in the capitalistic economy.[39]

Other theorists of this course did not even make such a small step forward as Hilferding did. For example, Otto Bauer argued, and even documented his arguments with facts, that social changes might be achieved by organization of the labor movement into trade unions.[40] Although he himself opposed the postulates of what could be conditionally called pure Marxism, his works were filled with wordings such as the 'industrial fights'.[41] Even though it organizes members per their place of work, syndicalism has little in common with economy. Its goals and its methods of fights are political. It is a social arrangement,

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[38] 'Matters are different in a society which lacks this conscious organization. Such a society is dissolved into a large number of mutually independent individuals for whom production is a private matter rather than a social concern.', ibid.

[39] 'It is only this act (exchange) which establishes connections in a society otherwise dismembered into disparate units by private property and the division of labour. Exchange is the subject matter of theoretical economics only because, and to the extent that, it performs this mediating function in the social structure.', ibid.

[40] 'The period of prosperity enabled the trade unions at that time to increase their membership enormously; in two or three years their membership grew from 189,000 to 501,000.', Otto Bauer, *Dangers of Reformism*, 1913, www.marxists.org/archive/bauer

[41] 'An exceedingly great number of *industrial fights* (italics by the author) resulted in an increase of wages, a shortening of the hours of labour, and advantageous agreements.', ibid.

oriented towards changes in society and in the political system, and only when these are implemented, would it deal with economy, utilizing political means. This aspect of Austromarxism too is devoid of understanding of the social character of economy as its essence, but as something imposed from the outside, like a Procrustean bed made for it.

The greatest significance of the Austromarxists is that they diverted the main course of the economic thought from the blind track of theoretical Marxism, without even knowing it. They tied the notion of economy with the notion of democracy and the concept of democratically organized society. They extracted, made the most out of the Marxism, or more appropriately: What was the most in touch with reality.

Undoubtedly, this too was in Hayek's mind when he claimed that the main credit of Marxism was the fact that it was the first to observe the connection between capitalism and the free market with the development of democracy.[42] However, not even in Marxism and its most liberal form – the Austromarxism, did this thought develop to the end, to its logical consequence: If the free market was a precondition for the development of democracy and therefore as an economic institution undoubtedly influenced the organization of the social, then democracy too as a way of organization of the social would evidently be lost with the abolition of the precondition of the free market.[43]

It would be most precise to say that Marxism and even Austromarxism did not consider democracy to be the best way of organization of the public life within society. Therefore, the free market had no importance as it did not lead to what this school recognized as the goal of all social activities. Never leaving the concept of the social revolution, Karl Kautsky, surely the most exemplary representative of the school acknowledges only the limited range of democracy. Recognizing all the merits of parliamentarianism, Kautsky sees democracy, in his work *The Social Revolution,* only as the general setting, as 'light and air", whose sole purpose is to prepare the proletariat and its representatives for the final social revolution. It is essential, but only and solely as the

[42] '... Marx was the first to see this. He is the one who informed us, looking backwards, that the evolution of private capitalism with its free market had been a precondition for the evolution of all our democratic freedoms.', F. A. Hayek, *The Road to Serfdom*, p. 116, The University of Chicago Press, 1994

[43] '... if this was so, these other freedoms might disappear with the abolition of the free market.', ibid, p. 116

previous step in the development of the social order. The entire society is viewed against the backdrop of proletariat and its 'opponent'.[44]

Relations between the economic and the social, their objective perception and consistent expounding, their development and many-sidedness, were evidently all left to wait for some other theorists.

I.1.5. From an individual to society

The other theorists started to emerge at the same time as Marx did. The other large economic and theoretical school appeared at first as a school of social arrangement, the school which broadened its fundamental teaching of liberty of individuals to economy and what we call nowadays – the Neoliberalism. Among others, one of the progenitors of this course of theoretic organization of the social and economic actuality is the French politician and theorist Frédéric Bastiat. Bastiat was forceful in his arguments and nothing less convincing than Marx in proving that liberty of any individual and the right to private property and life were the fundamental principles of any social organization claiming to be civilized. However, although focusing primarily on the social and political system of contemporary society, while doing so he starts from economy and emphasizes the importance of economic relations with regard to political relations. In one of his few works entitled *The Law*, at the very beginning, he associates economy with a variety of natural resources and their conversion into products – seemingly nothing new.[45] However, later in the text, expounding on the

[44] 'Democracy is also indispensable as a means of ripening the proletariat for the social revolution. But it is not capable of preventing this revolution. Democracy is to the proletariat what light and air are to the organism; without them it cannot develop its powers. But we must not be so occupied with observing the growth of one class that we cannot see the simultaneous growth of its opponent. Democracy does not hinder the development of capital, whose organization and political and economic powers increase at the same time as does the power of the proletariat.', Karl Kautsky, *The Social Revolution*, Volume I, The Social Revolution, Part 3, Democracy, 1902, www.marxists.org/archive/kautsky

[45] '...Il (le Bon Dieu, author's remarks) nous a plongés dans un milieu d'éléments divers. C'est par l'application de nos facultés à ces éléments que se réalise le phénomène de l'*Assimilation*, de l'*Appropriation*, par lequel la vie

subject what the law should protect, he asserts that politics in society should acknowledge economic interests established within it. He claims that a science of economics must be developed before a science of politics can be logically formulated and that economics is the science of determining whether interests of human beings are harmonious or antagonistic. This must be known before a science of politics can be formulated to determine the proper functions of government.[46] Bastiat was the first to clearly start from society as a group of individuals who possess their rights and interests, since the existence of persons and property preceded the existence of the legislator. In order to satisfy their interests persons unite in society. As human interests are of economic nature, then the organization of public activities in society – politics, must rely on recognition of economic interests meaning that the role of the legislator must not be larger than protection of person and property.[47]

I.1.6.The social character of certain economic phenomena

The beginning and the first half of the previous century were the times when the notion of the social character of economics was clearly formulated, the times when the key thinkers pointed out the importance of the relatedness of economic and social processes. This was clearly and unequivocally demonstrated in works of John Maynard Keynes, firstly through a study of an issue and later by expanding the subject of the study to certain economic phenomena and their influence on movement of processes that link economy and society, such as unemployment. He was the first to look into the effects of individual economic phenomena on society as a whole, and the first to examine systemically and comprehensively the mutual effects of political and economic processes on society.

The problem of reparation due from Germany for the damages

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parcourt le cercle qui lui a été assigné', Frederic Bastiat, *La Loi*, http://bastiat.net

[46] '...L'économie politique précède la politique; celle-là dit si les intérêts humains sont naturellement harmoniques ou antagoniques; ce que celle-ci devrait savoir avant de fixer les attributions du gouvernement', ibid.

[47] *The Law*, Frederic Bastiat, according to the Serbian translation of the American issue, *Zakon,* Global Book, Novi Sad, 1998, p. 82.

resulting from World War I after its surrender, served as an incentive to Keynes to prove that political solutions imposed on economy inevitably led to certain social changes.[48] The main confirmation of his assertions made in *The Economic Consequences of the Peace* was the historical train of events itself.

The Great Depression in 1929 was an additional enticement for this theorist to be concerned with economic problems in search of their effects on social phenomena. One of the phenomena commonly found both in economy and society was unemployment. Scrutinizing it in his study *Treatise on Money*,[49] and especially in *The General Theory of Employment, Interest and Money*,[50] he explored its connection with something considered to be strictly an economic topic until then:

Keynes clearly demonstrated that shaping of economic parameters might affect certain social phenomena. His immense accomplishment which is applied in policies of many government administrations throughout the world is the active approach of policies, that is, of political institutions to addressing economic problems,[51] in order to influence society reflexively. Once more he has taken on a topicality owing to the global economic crisis we are faced with.

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[48] John Maynard Keynes, *The Economic Consequences of the Peace*, published in 1919

[49] *Treatise on Money*, John Maynard Keynes, published in 1930

[50] *General Theory of Employment, Interest and Money,* John Maynard Keynes, published in 1936

[51] 'For whilst it indicates the vital importance of establishing certain central controls in matters which are now left in the main to individual initiative, there are wide fields of activity which are unaffected. The state will have to exercise a guiding influence on the propensity to consume partly through its scheme of taxation, partly by fixing the rate of interest, and partly, perhaps, in other ways. Furthermore, it seems unlikely that the influence of banking policy on the rate of interest will be sufficient by itself to determine an optimum rate of investment. I conceive, therefore, that a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment; though this need not exclude all manner of compromises and of devices by which public authority will co-operate with private initiative.', John Maynard Keynes, *General Theory of Employment, Interest and Money,* BN Publishing, 2008, p. 236

I.1.7. Freedom of economy and society

Friedrich Hayek, one of the most prominent individuals not only in liberalism but in economics as well, was the one to most clearly point out the entire importance of economic activities, primarily commerce, to the emergence and development of modern, free societies. His starting point does not differ from Bastiat's. People are free or should be and as such have certain rights. Although founded on antique thought, these rights were not readily attainable at the very beginning of the development of society, and not even in the course of its major part, but only in contemporary times, times which might be called modern, the emergence of which Hayek associated with the Renaissance.[52]

According to this theorist, the main origin of the development of free society, with all intermingled activities it comprises in itself, with unalienable rights of persons, with all its institutions guarding such rights and developing instruments of their application, all of this we owe to the development of economic activities. Wandering groups of caravaneers, the itinerant merchants of the Middle Ages, those with dusty feet from travelling to and from fairs and marketplaces (those literally called in the French Medieval language: '*les pieds poudres*") present the foundations of all we consider today in social relations and in the organization of society to be civilization accomplishments.[53]

The social character of economy reaches its full significance and affirmation in the works of Hayek. According to Hayek, economic activity creates a stratum of people who wish to preserve its freedom. This refers them to the public activity of building institutions that protect their other freedoms too, in addition to the economic freedoms. Finally, this course of development leads us in response, to economy, as once established institutions of the entrepreneurial stratum of people not only protect, but

[52] '... But the essential features of that individualism which, from elements provided by Christianity and the philosophy of classical antiquity, was first fully developed during the Renaissance and has since grown and spread into what we know as Western civilization - are the respect for the individual man *qua* man...', F. A. Hayek, *The Road to Serfdom*, The University of Chicago Press, 1994, p. 17

[53] '... The gradual transformation of a rigidly organized hierarchic system into one where men could at least attempt to shape their own life... is closely associated with the growth of commerce.', ibid, p. 18

also instigate both commerce and economic activities in general.[54]

The development of economic and social freedoms incited the development of free thought providing the impetus for sciences and thus again adding to the further development of not only economy, but society as well. It is logical then to claim, when the social character of economy is understood in such meaning, its full meaning that economic freedom is in the root of the total human development.[55] The social revival and the revival of civilization, thus commences from economic freedom understood as the right of a person, an entrepreneur joining other entrepreneurs to protect that freedom; their joining together leads to a social organization with its institutions which in turn further instigate economic activities; all of these induce progress in all areas – economic and social and scientific.

The gravest peril facing such development comes from institutions of the social system that might strive to expand their influence upon society, by undermining the 'system of freedom" and to establish a higher cause of social organization suppressing economic freedoms and the very essence of organization of persons into society for the sake of this cause. Therefore, the assault upon economic freedoms is made equal with the assault on political and general social freedoms and values. There is no society without economy and consequently there is no free society without free entrepreneurship and market where free economic activities are exercised.

The teachings of Milton Freidman elaborated these points of view and develop them to the utmost limits. As opposed to Keynes's views which Friedman shared with him at the beginning of his career, Friedman believed that it was difficult to find vindication for interventions of government institutions in economy. He even considers the Great

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[54] '... The conscious realization that the spontaneous and uncontrolled efforts of individuals were capable of producing a complex order of economic activities could come only after this development had made some progress. The subsequent elaboration of a consistent argument in favor of economic freedom was the outcome of a free growth of economic activity which had been the undesigned and unforeseen by-product of political freedom.', ibid, p. 19

[55] '... Only since industrial freedom opened the path to the free use of new knowledge, only since everything could be tried... has science made the great strides which in the last hundred and fifty years have changed the face of the world.', ibid, p. 19.

Depression big, because of inappropriate reaction of monetary authorities in the United States of America.

In his opinion, economic developments cause the best effects in a defined entrepreneurial system, if left alone. Social phenomena, i.e. economic phenomena with deep social implications such as unemployment for example, owe its development to economic processes, that is, to movements on the labor market, its state and imperfections.

He certainly does not dispute the influence of economy on society, its structure, political processes. On the contrary, he is completely aware of all that economic system causes in the social sphere. The reflexive mechanism on economy exerted by the social sphere does exist after all, even when there is no governmental intervention that Friedman so fiercely opposes. That reflexive mechanism on economy is based not on institutions of the political system but on individual effects of participants in economic processes. Therefore, he completely relies on expectations of rational behavior from them.

The viewpoint he supports is not to influence economy through political processes, but vice versa, to utilize economic means in exerting influence on certain political and wider social events and arrangements. If a society is to be free, it must rest on free economic relations.[56]

Economic freedom is itself a component of freedom broadly understood, so economic freedom is an end in itself,[57] in addition to this, maybe even more importantly it is the foundation of political freedom, otherwise unachievable on other economic grounds. With this viewpoint, Friedman provides unbroken continuity after his predecessor, Frederick Bastiat, who was the advocate of inevitable supremacy of the economic over the social.

The most prominent and most mentioned example of accuracy of Friedman's viewpoints is Chile, where the economic policy was defined by his champions. This economic policy revived the Chilean economy, restoring its tendency to grow and stable character and most importantly

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[56] '... that there is an intimate connection between economics and politics...', and further on: '... economic freedom is also an indispensable means toward the achievement of political freedom.', Milton Friedman, *Capitalism and Freedom*, p. 8, The University of Chicago Press, Chicago and London, 2002

[57] '... freedom in economic arrangements is itself a component of freedom broadly understood, so economic freedom is an end in itself.', ibid.

added to the reestablishment and strengthening of the middle class. The middle class as a social stratum with democratic system as its natural environment, striving for its political freedom was partly the cause of the fall of dictatorship and revival of democracy of people in Chile.

His adherents from the Chicago school of economics prided themselves on other examples of success, and as of recently on Ireland, Iceland and Estonia. However, what happened in their economies in the course of the global financial crisis, does not single them out as good examples anymore. The superficial criticism of how everything was caused by deregulation and that economics without a political factor could not rely on growth and success in the long run, should not be directed to those advocating Friedman's ideas.

Nowhere in his work was deregulation promoted as an unorganized process. If economic processes unequivocally affect the structure of society and its arrangement, then it is very important that measures taken in economy be applied carefully and wisely. Therefore deregulation should be planned and efficacious, and not unorganized. After all, any unorganized measure can only induce effects proportionate to and suitable for such measure, proven by the current crisis along with the entire pre-crisis period.

Moreover, the idea that free economy means a completely unregulated economy is wrong. A solid legal framework and clear rules are necessary to protect these freedoms of such an economy, and society based on it. Within economy, the capital market serves as an evident example that an area which is highly regulated enjoys full freedom of processes, with strong protection of property and therefore, institutionalization of confidence.

Views which can be deduced from Friedman's teachings, brought to the extremes, point out that society is of secondary importance in relation to economy. Social institutions, processes in it should be left aside as what occurs in the sphere of economy would have a dominant influence. Research of social institutions makes sense only to the extent to which it is necessary to provide conditions for unhindered economic processes.

Therefore, it is more efficient to focus on economic measures, primarily monetary measures and provide the highest degree of freedom possible there, and society will follow that freedom, itself becoming free.

It was easy to slip to extremes in practical application of the model, the extremity neglecting some of the effects of economic measures and which did not necessarily lead to prosperity of members of a society. From the viewpoint of methodological approach, Friedman believes that categories 'good' and 'bad" cannot be applied to economy. These are the categories of moral nature, but first and foremost morals are a social phenomenon.

What is important for economy is how capable it is to develop a model in which forecasting of future events would be the most efficient and what makes it neutral from the moral viewpoint of values.[58] Obviously, here lies a contradiction: The claim that economy and society are intrinsically interwoven, cannot lead us to the point where in such a way socially connected economy could completely keep off any social phenomenon including morals as well.

Keeping off the moral norms which exist only within social processes and relations, represents a departure from a large portion of the social, from what is going on in it, and from what is happening with it, no matter whether it is caused by economic measures and processes. The viewpoint about neutral economy in terms of values can only rest on axiomatic acceptance that if a measure is good for economy, it is also good for society and any of its members.

Moreover, by application of further logical elaboration this can easily take us to the terror of efficiency and the terror of profit. Friedman himself says that the only purpose of companies is to generate profit. There is no fault in it, but such a viewpoint is a real incentive to ask why should one engage in economy and what is its final goal and matter? Is it to study the behavior of companies in order to maximize efficiency and profit or the prosperity of a community and its members that economic activities emerge after all? There is no latter without the former, of course, but the former becomes meaningless without the latter.

This is the right axiom, the one that should be a starting point when studying the social character of economy. Hence, it is necessary to include something more than mere mathematics in the observance of economic phenomena and their effects.

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[58] About criticism of the Friedman's methodological approach (published in the treatise *The Methodology of Positive Economics*, 1953), please see in detail Francesko Guala, *Filozofija ekonomije*, CID, Podgorica i Politicka kultura nakladno-istraživacki zavod, Zagreb, 2010, p. 75-88.

I.1.8. From an individual to economy

As seen by Friedman's followers, a member of a social community should behave economically and rationally and recognize self interest at any moment and to strive to gratify it as much as possible. Put in other words, when it comes to economy, they should follow interest, which will lead them to as much profit as possible, while the logic in making decisions should not differ from the logic of capital.

Several groups of economists disputed this approach. They are referred to by a mutual name of Heterodox economists.[59] In their opinion, a person lives and is formed in an environment, social and economic. This environment affects formation of their views of the world, fundamental viewpoints, the art of communication, which all together place them in a situation to make each decision in a certain context, from which they cannot escape.

This does not make them preordained for non-freedom, or utmost determinism, which is the same at the end. The freedom of any person to act remains indisputable, save for the Marxist theoreticians who also belong to the group of Heterodox economists.[60] The way in which such freedom will be used depends largely on the mental model of the one making such decision.

On the other hand, mental models are complex and defined by instincts transferred as genetic heritage, that for example determine the art of communication through the instinct of speech, habits acquired in the course of socialization, adopted behavioral models, capacity to thrive in some situations.[61] By making decisions in such a way, the individual

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[59] Heterodox economics should be interpreted here in its negative connotation in relation to orthodox economics, that is, in a certain time period and in certain institutionalized including academic and primarily academic, prevailing economic thought. It is therefore the case of different groups which disputed the prevailing neoclassical economic thought from the end of the sixties of the last century onwards, developing their own economic theories, pluralistic by its nature.

[60] In the quoted article of Mary V. Wrenn, *Agency and Mental Models in Heterodox Economics*, Heterodox economists are classified into five groups – in addition to Marxists, there are Institutional economists, then Neo-institutional economists, Post-Keynesian and followers of the Austrian school of thought.

[61] '... primacy on a more complete ontology of the individual, playing close attention to the cultural mechanisms which shape and channel the

affects its environment, and then the environment affects in response the individual and members of the social group, transposing effects of their decisions through institutions. Heterodox economists emphasize individual activities of persons and use this as a starting point, save for the Marxists, but they always place it in the context of interdependence with other individuals. Social and economic processes are formed likewise on interdependence of individual activities.

Reactions of individuals and their activities are foreseeable, often routine, bearing in mind their cultural and social backdrop. This makes economic forecast possible, but requires other elements from other social sciences to be integrated in the study, for example from personality psychology or crowd psychology. Thus, some theorists tried to explain not only the far-reaching effects of crises, but their causes as well, by behavior of market participants, when making economic decisions.

John Kenneth Galbraith, the most famous economist of the Institutional school of economics is the most prestigious among them. In the book *A Short History of Financial Euphoria*[62] he illustrates how creation of speculative bubbles and their bursting cannot be understood without the knowledge of the crowd psychology.[63] His work was directed towards proving the need for greater participation of the public sector in creation of the economic environment, thus affecting social developments, steering them in a specific direction.

I.1.9. From economy to an individual

Public choice theory had a considerable impact on the relation of economic private interests and what happens in the public sector. It

individual's mental models.' and further on: 'Instinct, habit, and patterns of behavior form the building blocks of the individual's mental models.', Mary V. Wrenn, the quoted article

[62] John Kenneth Galbraith, *A Short History of Financial Euphoria*, published in 1994

[63] Every intermediary on the financial market knows that the highest danger for his occupation lies in the mentality of investors, described as the phenomenon of pigeons – they flock to the market quickly when its rising contributing to its growth and fly away as quickly at the first sign of instability, contributing to the fall of the market and their own loss.

completely embraces the impact of the economic factors on the social and especially on political movements, where the political means the processes set and implemented by individuals in institutions, tasked with addressing the issues of public interest. Public choice theory teaches that individuals, on whose activities the implementation of processes in institutions is contingent on, will look after their own personal and individual interests and strive to serve them before the general interests, while they would act in the public interest only if it matched the personal.

The most renowned representative of this school of thought is James Buchanan, who explained in his work *The Calculus of Consent*,[64] coauthored together with Gordon Tullock, that in order to grasp what kind of decisions would be made in the organization of social institutions, not only the legal framework of their actions or the organizational schemes of the decision-making process should be analyzed, but also the private interests of those who order collective activities. The consideration of private interests, primarily their acknowledgement and then their introduction in the theoretical analysis, practically made the direct link between economy, via an economic category, with movements and processes which are above all social and to be more precise – political. This theory provides concrete answers to why some individuals in a society or a social group or organization behave in a certain way. This approach represents definitely a breakthrough in the political science, and in grasping economy as well, especially where it stretches and what the consequences of the economic way of behavior in society are.

Still, it remains unexplained how economic movements, their convergence and totality of processes in the economic sphere influence the formation of groups in a society. What kind of processes are at work, how are these processes implemented and what kind of results would they yield under various conditions? Let's take for example the state authority in charge of privatization. Certainly, a myriad of private interests can be discovered, which within given procedures may tilt certain privatizations to a direction. However, we still do not know where the privatization is to take us, what kind of social system it is to form, and in what way it is possible to marry the private interests with the public,

[64] Buchanan, James M. & Tullock, Gordon, *The Calculus of Consent*, published in 1962

how to enable private interests to be served in implementation of the policies such as privatization, not to the detriment of public interests, but serving the best interests of the public.

Public choice theory does not disprove that private interests and serving the private interests will lead to serving the public interests of strengthening economy on the market of private goods and private capital. It proves that the private interests of those entrusted with taking care of the public good, those leading the institutions of the social system endanger and even nullify their ability to take care of the public interests.

Taking this assumption as correct, it is possible to point out how the simple solution lies in entrusting as many public activities, activities serving public interests, to private ownership and the private capital market. Even if it is not possible with the urgent medicine services or defense, it is certainly possible when it comes to public utilities, state monopolistic energy companies, public transportation etc., by using shareholding as a method.

Shareholding is the most straightforward way to make economy social, while keeping it in private hands. The higher the dispersion of ownership, the wider the ownership structure, the more likely the mass of private interests, striving for their gratification, will ensure the most efficient care about public goods and interests. As explained further on, this is even more straightforward as the fundamental principles of shareholding are identical to those on which political democracy rests, and some of the principles are even embodied in economic democracy – shareholding.

I.1.10. Democratic control of capitalism

This is how the effective link between the social and economic is established through shareholding. Its institutions provide mutual effects of the economic sphere on social and vice versa, in the constant process of exchange of information and influences molding the flows of economy and society. Unfortunately, we have seen that this link is in the focus of the both general and the expert public, at times of crises, when it is spoken of as something negative, which should be avoided by strict separation. Long periods between crises, certainly longer than the crises themselves, characterized by progress they bring and economic development, progress in society and for all of its members are forgotten at such times.

Interdependence of a specific social model and economic behavior within it was a prominent feature and it was observed as if by a rule, during all economic crises especially in times of crashes of capital markets. From the first documented crash – the Dutch Tulip mania in 17th century[65], to the Great Depression and the economic crisis in 1997 and the current one, the irrational behavior of participants stands prominently.

The first-hand experience during the global financial crisis in 1997 helped George Soros to formulate the theoretical importance of the capital market to society. He asserted in his work *The Crisis of Global Capitalism*, using facts gathered by direct involvement, that open i.e. democratic society can be equally at jeopardy from within, because of absence of the relevant regulations, which does not provide for the social cohesion.

He believes that volatility is an intrinsic quality of financial markets, and fears that such volatility might be transferred to society as a whole, and therefore advocates higher presence of social institutions in financial markets. Some needs of society might remain ungratified and they might become permanently endangered, if absolute freedom of the market is allowed.

Of course, he does not question democracy, or the free market as the most desirable systems of organization for society and economy. He merely believes that their relation should be balanced, in equilibrium, as they obviously affect one another, establishing interdependency between them. Overcoming one or the other, the social in terms of authoritarian closed regimes or the economic in terms of something he names ‘market fundamentalism’, imperils the one and the other.

All market participants make decisions starting from their own interest, but as members of society, participants blend in the general interest and make decisions based on a wider cause.[66] Finally, Soros

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[65] Burton G. Malkiel, *A Random Walk Down Wall Street*, W. W. Norton & Company, New York, London, 1999, p. 36-39

[66] ’As a market participant, I try to maximize my profits. As a citizen, I am concerned about social values: peace, justice, freedom, or whatever.’, George

believes that democracy and capitalism are not inevitably linked, but have to be linked as capitalism particularizes consciousness, does not allow rising above personal interest, which always returns to maximizing profits.[67] That is why the regulative role of a state is necessary, in order to transpose this kind of market behavior to generally acceptable public policy.

I.1.11. Intertwining and interdependency

This interdependence scheme of members of the social community and economy their reflexive mechanism,[68] is known to everyone who had had a chance to directly observe processes of transition in a society. The state would for example distribute shares of state companies to citizens, turning state ownership into private property. However, citizens have little knowledge of shares, what they are and what rights arise from them – it is their 'mental model", and it is the model of at least several previous generations, formed in so called socialism, where the concept of ownership and rights arising from ownership was unknown.

What should be a rational expectation is that each citizen – shareholder would not sell shares, unless absolutely necessary till the end of the transition and the recovery of the economy. This has not been the case. The first takeover offering made to shareholders of a company caused that they behaved as reluctant holders whose only wish was to lay hold of the only thing they recognized as a value – money.[69]

It is indisputable that these shareholders made their decisions independently and freely. However, it is also evident that these decisions were not always in their economic interest. They were made rationally, based on premises available to shareholders, but these premises

Soros, *The Crisis of Global Capitalism*, Public Affairs, New York, 1998, p. xxv

[67] 'Capitalism needs democracy as a counterweight because the capitalist system by itself shows no tendency toward equilibrium.', ibid, p. xxvii

[68] '... the individual agent makes choices within a cultural context and the choices influence the very social structure wherein the original choice was made.', ibid.

[69] The author has had plenty of opportunity to gain firsthand experience of this kind of a behavior pattern, being a Commissioner and the President of the Securities Commission of the Republic of Serbia, for nearly a decade.

exceeded the economic sphere and went deep into the social and the individual and the psychological. These decisions were made in a real environment and there they created real consequences in economy. Rationality in making decisions is not an abstract rationality steered by decision-making based on clear economic parameters. As it is emphasized in the Institutional school of economics, it is 'bounded rationality', bounded by a series of non-economical postulates of its functioning.[70]

The consequences of such bounded rationality in economy are as personal as general, because in the case which we have taken as an example the case of shareholding in transition, instead of economy with wide dispersion of ownership, we get economy with concentrated ownership, therefore a completely different economic model.

In a series of other everyday situations, market participants react in a similar manner, making decisions that do not only depend on estimates of how to reap the highest profit possible. On the contrary, there are postulates in the process of decision-making concerning realization of economic activities that distort this assumed clear direction towards profit, changing therefore both the economic and the social reality.

According to these theorists, the intertwining of the social and the economic is complex and multi-layered, and their mutual interdependence is something that occurs at every individual decision and action, be it in the area of the economic or the social.

Finally, contemporary economic thought is inseparable from the analysis of the effects of economy on the social sphere and vice versa – the consideration of how social institutions in the widest sense, or just in the narrowest sense of states, affect the movements in economy. Still a line of separation can be drawn without much effort between two big groups, with all of their differing views: the one where precedence is given to economy and one where precedence is given to society.

In such a differentiation, the criteria for the line of separation would be what the fundamental goal of economy is, and how to reach it.

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[70] '... bounded rationality... address the ontological nature of the filtering of data through mental models and mental model construction.', and further on in the text: The individual's mental models imbue incoming data with meaning and situate it within a familiar frame of reference, thus bounding rationality by cultural and contextual specificity.', Mary V. Wrenn, the quoted article

At the end, no one would dispute that the end goal of economy is betterment for all members of a community carrying out such economic activities. Theoreticians who, for example, continue the work of Milton Freidman, those most often called neoliberals, believe that the focus should be placed on enhancing conditions for the performance of economic activities, in terms of minimizing obstacles and burdens, which is to free the entrepreneurial spirit of society members and to incite them to strive to attain economic progress for themselves and for their families.

Thus Hernando de Soto holds that the registration of all goods at the disposal of individuals in a society, primarily real estate, would lead to their clear formalization and simpler uptake of their function in economy.[71] According to him, the fundamental role of a state, emanating from an organized social community would be registration of goods and elimination of obstacles for their trading. This is to induce creation of greater social wealth, which all of its members could enjoy, or at least an optimally large number of society members.

On the other hand, Jospeh Stiglitz highlights market inefficiency in his work. He argues that measures directed only at increasing the volume of an economy or economic efficiency will not bring about the general social progress. [72] Analyzing again the notions pertaining to the welfare state, he dwells on Pareto efficiency, proving that without additional efforts from the state, it is impossible to achieve effects in the economy that would be beneficial to all members of a community, without damaging the interests of some of them. The role of the state must therefore be more active and directed at more equitable distribution of economic effects across all members of society.

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Without taking sides or evaluating any of the arguments here, it is important for this study to acknowledge that the social character of economy was accepted fully, in the course of its development, theoretical

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[71] ‘Capital... is... a dormant value.’, Hernando de Soto, *The Mystery of Capital*, Black Swan, 2001, p. 43

[72] *Economics of the Public Sector*, Joseph E. Stiglitz, the issue in Serbian *Ekonomija javnog sektora*, Ekonomski fakultet, Beograd, 2008.

organization and contemplation. Perception and comprehension of economy has come a long way, originating in the description that economy is an art of managing goods. From Adam Smith onwards, its social character is easily observed. Once noticed, the social character of economy could not have been ignored anymore. Every subsequent theorist, each subsequent school of thought, striving to explain its ways of functioning, had to deal with that side of economy as well.

Some of the schools underscored the social context in relation to economic activities taking place in it. Some went a step further expanding upon the need of social activism relative to the economic sphere for the purpose of a higher cause of economy and society. Those who based their study on teachings of Keynes linked the effects of the social on economy with institutions of the existing system that would enhance economic developments by their activities.

However, schools such as Marxism were distinctive in conscientiously overlooking laws of economic activities, although they did recognize them, but chose rather to subject them to political arrangements of economy. The final emphasis with them is placed on the social sphere, the rearrangement of which would lead to rearrangement of economic relations.

On the other hand, others were aware of the importance of the social element in the functioning of economic developments and they advocated constructing an environment for economy to evolve. Like Smith, they proved that a specific social environment was good for a specific type of economy, emphasizing that there were certain legal postulates, such as freedom or private property. These are achievements of civilization, without their application and elaboration within the legal system; there could be no economic progress as Čedomilj Mijatović explained in Serbia.

Finally, in its theoretical development, the study of economy gave rise to schools that acknowledged the importance of the social character of economy and examined and attached a predominant importance to the influence of economic factors on the social. These theorists extrapolated the social reality from economic developments. And again, some among them emphasized the reflexive mechanism of the social to the economic, while others underrate this aspect.

The development of an understanding of economy was not one-way, nor did it constitute a gradual and even development of theory. Different schools of thought were present concurrently. One championed primacy of the economic over the social and others in contrast explained why state interventionism was unavoidable in economy. Theorists of the first and the latter presented very strong arguments defending their viewpoints that stood in their elaborated systems valid and irrefutable.

Turning to practice, the final judge of validity of one or the other school of thought, we can see that both arguments when applied (from period to period, from one social-economic moment to the other) ensured economic advancement and social progress. To sum up, what is indubitable is the fact that interrelatedness of economy and society cannot be disregarded. It is a given fact.

The crash of financial markets in 2008 and the one in 1929, demonstrated how a deep and wide connection there is between economy and all other areas of society, i.e. how much attention one must devote to the study of these connections, and that moreover, they should be primary in relation to so called technical analysis or macroeconomics. Economy is a set of activities which developed from the need to survive, the preservation of life in society and the life of society itself. And life is just simply too complex to be explained by a set of formulas and charts.

Economy is a set of activities with the goal of personal and family betterment, not as an individual, personal/family activity, but rather as an activity undertaken in a social environment and exerting influence in the social environment in a setting of a social community. Understood in this way, it constitutes a breakthrough of civilization in the formation of society as an organized community. For only organization could be the answer to uncertainty of economic affairs.

Likewise, economy is even more that a mere sum of activities in a society, oriented towards the personal and family betterment. The total of these and such activities produces new quality, yields economy of an entire community, i.e. society. The connection that leads to social activity from individual/family activities, what produces a resultant of all economic companies in a society and what brings us to the general quality/universality of the term 'economy" are the institutions and procedures therein. Economic activities take shape in the system of procedures nurtured by institutions in a society, providing them an environment to develop and ensuring preconditions on which economic activities rest. As an economy develops, its environment changes too, transforms and develops, which in turn affects the economy in the course of further shaping activities by adjusting procedures.

Surely, such interdependence must be observed, monitored and studied in order to be evenly secured and, if necessary, encouraged in certain directions. This very interdependence is itself complex and compound. It occurs concurrently, at several levels, on multiple conjunctions and in different ways.

One of the conjunctions is for example the capital market where capital itself is a means of connection through the institution of – the market. Capital too is a social-economic relation, as it constantly generates social-economic relations. This generating, forming of social-economic relations must happen in an institutional manner, through institutions and procedures therein, based on defined legal postulates. Thus, the market is an institution and shareholding is a social-economic phenomenon, which shapes into legal postulates through rights of shareholders. The trading of shares is a procedure, as is the voting at general meetings of shareholders, or distribution of dividends, or disclosing information.

CAPITAL ACTIVENESS

I.2.1. Etymology as an outline of essence

Capital can be anything, but idle. Activity is the word that best sums up the very essence of capital – its *raison d'être*. It is how assets and money will be named, but such naming will be correct only if they serve a particular function – a particular use. We say 'particular', because not every use of assets or money generates capital.

The use should be such that it engages assets or money for the production of new assets or the provision of services, which can be sold to others who do not own capital. The personal use of assets or spending of money for personal needs will not turn them into capital. On the contrary – it will annul any possibility of their becoming capital for the then owner.

The etymology of the generally accepted word that designates capital reveals a lot about its concept in almost all languages. The word 'capital' derives from the Latin word 'caput', meaning 'head'. The word was used to designate heads of cattle that were synonymous with wealth, just like some Slavic languages have preserved the synonymous meaning of words 'cattle' and 'wealth'.

Long before it was possible to image any theoretical pondering on the origin, maintenance and multiplication of capital, such use of the word 'caput' implies that those who dealt with it were familiar with the basic features of capital. Just like capital, cattle is linked to someone, it is someone's ownership and accumulated wealth and is therefore in a personal relationship with the owner. The owner can use it for personal purposes as well, thereby reducing his accumulated wealth.

The owner can also sell it, i.e. trade in it and thus make profit. To achieve this, the owner enters into particular relations with others – these relations can take root and, later on, be reproduced and developed on their own.

Most importantly, cattle can regenerate and grow by means of reproduction, just like capital has the capacity to grow. To make this happen, particular care should be taken of the herd, just like particular care is taken of capital, i.e. capital should be invested and traded in a specific manner, enabling, once again, the creation of particular social relations around it.

I.2.2.The personal and social

In the first treatise on economics, after which economics were named, Xenophon, the author of the treatise, identifies the difference between assets serving the function of further production and assets for personal consumption only. Capital exists only within turnover. Since then, this knowledge has not been disputed. Whatsoever, it has become axiomatic.

Xenophon writes the treatise *Economics* to explain how assets are managed with a view to increasing them. His approach is personal and he perceives capital as someone's ownership or property. In the Serbian translation of 1862, the term 'property' is used, i.e. someone's personal, private ownership. Though using always the same word in the treatise, it is clear that the author makes the difference between what we call 'capital' today, i.e. something active, and property that is not active.

Moreover, a personal approach is reflected in the utility of property. What may be useful and usable assets for someone are of no significance for someone else.[73] In this personal approach, utility is the criterion determining whether something is capital or not.[74] This relates to all types of assets and it also relates to money – money is capital only for those who know how to use it and draw some benefit from it.[75] In the last instance, Xenophon also proves that both friendship and enmity, if used for someone's benefit, may be considered capital.[76]

[73] 'In this way, these objects are property for those who know how to manage them, and are not property for those who do not know how to manage them', Xenophon, *Economics*, rendered into Serbian by Jevt. Avramović, published by J. Kumanudi, Belgrade, 1862, p. 5.

[74] '... property is everything what is worthwhile to someone', ibid, p. 4.

[75] '... money is not property if one does not know how to use it, ibid. p. 5.

[76] Today we would call it: 'social capital'.

In addition to the personal approach, i.e. use for someone, the treatise also focuses, though not directly but clearly enough, on another fact relating to the appearance of capital. Namely, though based on someone's property, capital is created only in the relationship among people. Neither trade nor production are categories existing on their own and for themselves, separated from society and economy. On the contrary, as is the case with the provision of services, the movement of assets and their turnover, either in the form of particular assets or money is an indispensable environment built by people among themselves.

To make capital out of particular assets, these assets have to enter the social environment of trade or production. By entering this environment, mutual relations are created among the owner of assets and those purchasing them, or processing or trading in them in any way, and thus creating capital with such assets. Therefore, since its appearance and throughout its development, capital has been marked by duality: it is created from private property related to a concrete person, but it cannot be achieved and developed as capital without a social relationship.

I.2.3. From money to more money

In the course of its development, economic theory has produced varying approaches and attempts at defining capital. Some theorists tried to fathom the very essence of the origin or transformation of particular assets or money into capital, while others cherished a descriptive approach, by systematizing capital as a phenomenon, without pondering deeper reasons for its appearance.

Among the first theorists, one is inescapable, no matter whether we agree with his ideas or not – Karl Marx dedicated most of his theoretical work on comprehending the appearance, maintenance and increase of capital. In his view, a set of relations established in these processes make the essence of the capitalistic way of organizing production. Marx explains the 'secret' of capital in his first volume of 'Capital'[77] through transformation of money into capital.

[77] Karl Marx, *Das Kapital, Kritik der politischen Ökonomie*, first published in 1867.

In the pattern of assets exchange, with money featuring as the means and universal measure of value, and therefore the measure of the value of concrete assets being exchanged – everything starts and ends with assets. In 'Capital', this is expressed with a simple formula: assets – money – assets. This does not mean the creation of new value – money is only the means facilitating the exchange, while, in essence, equal values are being exchanged. Both assets, by the very act of their exchange contain the same value, and therefore each participant in the exchange receives as much as he gives.

Capital is created in the transaction where money is issued for particular assets that are thereafter sold so as to get more money. This is demonstrated in the pattern: money – assets – money, with money being increased at the end of the pattern. In such a relationship, the immediate participant in the transaction – the person giving money to buy assets, places no interest in assets whatsoever. What he is interested in is how to use these assets as a means so as to get more money than he invested.[78]

Interpreted consistently, this implies that money is within an exchange being turned into capital, which cannot be true. In the mainstream and on the long run, an exchange can be established only among equal values – it can create added value expressed in money and thus turn money into capital. We should go one step further into the analysis and accept Marx's, and not only his, attitude that value may be created only through human labor. Thus, labor only can create higher value.

Among the first, Adam Smith explained in detail the link between labor and capital creation. In his opinion, accumulated production means capital, i.e. inventories created over time, which can be used in further production.[79] By elaborating further on the concept of capital and the manner of its creation, in his *Wealth of Nations,* Smith claims that only some inventories of assets may be considered capital – those containing

[78] 'The tireless fertilisation of value… is achieved by a capitalist who all the time re-enters such value in turnover.', Karl Marx, *Capital*, I volume, Kultura, Belgrade, 1964, p.162.

[79] '... a certain quantity of labour stocked and stored up to be employed, if necessary, upon some other occasion.', furthermore: '... can afterwards, if necessary, put into motion a quantity of labour equal to that which had originally produced it.', Adam Smith, *The Wealth of Nations*, Alfred A. Knopf, New York, London, Toronto, 1991, p. 295

value. The value is, however, accumulated in products owing to human labor.

Nonetheless, according to Smith, not any kind of labor can create and accumulate value in products, but only productive labor. Smith clearly distinguishes among and enumerates productive and non-productive activities. One of the main measures of labor productivity, i.e. of labor that can create value is the possibility, according to Smith, that the product of such labor, after some period of time after the appearance, may be once again placed in the production function. In this way, it will free the value accumulated in it, through productive labor, and place it in the function of creating new value.[80]

Apart from the undeniable link between labor, i.e. productive labor, and the creation of value which, being accumulated in particular means, makes of them capital, it is clear that Smith also associated this entire relationship with production, i.e. turnover. Without placing into the production cycle a means whereby value is accumulated, it is not possible to create new value or new capital.

Similarly, Marx also believes that money being invested not in mere exchange, but in the purchase of those assets that can create value added by investing labor, is capital to be returned to the owner in an increased amount once the whole transaction ends. It should be underscored that Marx also believed that capital is linked to turnover and investment. Turnover itself does not make capital out of money. However, without turnover it is impossible to carry out the whole process of turning money into capital.[81] This is how capital is once again linked to particular relations that are established in society around it and because of it.

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[80] 'Whatever part of his stock a man employs as a capital, he always expects it to be replaced to him with a profit. He employs it, therefore, in maintaining productive hands only; and after having served in the function of a capital to him, it constitutes a revenue to them. Whenever he employs any part of it in maintaining unproductive hands of any kind, that part is, from that moment, withdrawn from his capital, and placed in his stock reserved for immediate consumption.', ibid, p. 296-297

[81] '... In the turnover money-assets-money, both assets and money function only as different ways of existence of the value itself because money is its general and assets its specific, or disguised way of existence', *Capital*, p. 162.

I.2.4. Slowness as a determinant

Change is the word accompanying the notion of capital of Vilfredo Pareto as well. He understands such change literally – as a change of physical features of matter in the production process; for instance, kinetic energy triggers the force that moves the watermill stone or transforms wheat into grits. He emphasizes that the study and description of capital always boils down to transformation in a particular time period.[82]

In his *Manual of Political Economy* Pareto distinguishes between capital assets and consumer assets. The distinction criterion is transformation over a particular time period, i.e. the degree of transformation and its duration. He considers capital those assets that are changed little or not at all; and if they change, that happens slowly.[83] By contrast, consumer assets last over one production cycle and cannot be considered capital.

In his approach, capital has a clear and solid form – it is concrete and it is implied that it is already engaged in the production process. However, Pareto concedes that a demarcation line between capital and consumer assets cannot be always clearly drawn, which makes his definition of capital imprecise. He thereby invokes sound reason, emphasizing that no one can say precisely when youth ends and adult age begins, but still, everyone can distinguish a young man from an adult man.

The problem of definition does not exist for instance in case of land where a plant is built – such land slightly changes over a long time period, i.e. it is capital. The problem occurs when a consumption part of a machine should be determined. While the machine itself, due to a sluggish change, is obviously capital, the part installed in it may be treated in a twofold way – both as capital and a consumer good. Pareto concludes the dilemma by referring to the accounting treatment of such part – he shows that from the viewpoint of overall production it makes

[82] '...il est nécessaire de tenir compte des transformations dans le temps.', Vilfredo Pareto, *Manuel d'économie politique*, Paris, ed. Marcel Giard, 1927., p. 296.

[83] 'On a donné un nom aux choses qui ne se consomment pas, ou qui se consomment lentement dans l'acte de la production; on les a appelées des capitaux.', ibid, p. 293.

no difference how this part will be treated. Namely, regardless of the accounting item, the final annual result will be the same.

Finally, we could say that Pareto also considered capital as a means active by its nature and linked to production. In other words, apart from production and turnover in general, capital is not even considered as it does not exist without such background.

I.2.5. Ownership of activity

This short overview of only some theoretical considerations of the essence of capital, its appearance and the transformation of particular assets into capital, including its trading and increase, still falls short of answering something that is the initial contradiction of capital: it consists of privately-owned assets which can become capital only in a specific relationship towards and with other people.

Resolving this contradiction entails an answer to the previous question – should the assets being transformed into capital be privately-owned? The Marxist theory gives a negative answer.

This answer is not original as numerous theorists before Marx elaborated on why capital not only should not, but also must not be privately-owned. Furthermore, if remaining private, it will give rise to numerous negative phenomena that, in the last instance, increase social inequality and trigger numerous other social anomalies. Finally, private property would jeopardize society and bring about its dissolution. Before the appearance of Marxism, Fichte seems to have gone farthest in developing the concept of a society based on an idealized understanding of property and social relations. Drawing on German classical philosophy and being one of its most important representatives, Fichte allows for ownership, but not over things; he unequivocally says that ownership over things cannot be permitted in terms of possessing a particular thing and preventing all others from possessing it.[84] He fully excludes ownership over land.[85]

[84] '... ownership without possessing anything…', '…there is no ownership right to things...', Johann Gottlieb Fichte, *Closed Commercial State*, Nolit, Belgrade, 1979, p. 59-61.

[85] 'According to our theory, ownership of soil does not exist at all', p. 59.

Fichte associates property with the ideal possession of a particular thing, basing it on his own theory of the first and initial property, which can be only the ownership right to a particular activity.[86] Only in relation to an owned activity is it possible to possess assets indispensable for the performance of such activity. The state should regulate, care for and secure the whole complex system of possession through an activity. In addition, the state should also care for the distribution of what is produced through a private activity on public assets.[87]

I.2.6. Capital and general ownership

No matter how nicely imagined and precisely elaborated, this system simply does not function, just like many others created after it and based on public ownership of goods, including Marxism. Not only has it been proven in theoretical discussions that these models are wrong, mistrustful of people and therefore misanthropic, but attempts at implementing them in practice have led to harsh imposition of relationships among people that have all shown themselves as inhumane and illogical, illogical both from the viewpoint of human and capital logic.

For a good in any form to be transformed into capital, it must start from a personal, individual interest. Private interests are opposed to one another, but their negation will not lead to their disappearance. Everyone has their own specific interests and views of how to satisfy them. These interests and views can partly or entirely coincide with interests and views of other people, or they can be wholly opposed to interests of third parties. Whatever the case, the only way to solve and satisfy them is their interaction.

In this interaction, the assets serving to satisfaction of interest become capital. Whether it will be defined and acknowledged as someone's private ownership or as a general good does not exclude the existence of a private interest related to it. In societies that are not

[86] '… our theory posits the first and initial ownership, the basis of any other type of property, on the exclusive right to a particular free activity.', ibid, p. 58.

[87] '… the very warranty to be able to always find work or a channel for his assets and that he will get for it a portion of fruits of land that he is entitled to.', ibid. p. 63.

formalized or that abolished private ownership of assets, all that happens is that interests are being met by the informal usurpation of what is legally considered a public good. In a socialist society or any type of dictatorship, interests will be met by someone usurping an asset based on political power. Such usurpation will not disappear in societies building democracy, such as countries in transition after the fall of the Berlin wall, as long as there is state ownership over particular assets. The division of the party prey after each election, in the form of allocating places in boards of directors of state-owned enterprises is a blatant example.

The state's care of individuals' private interests will be subject to the capitalization of those who have to implement such care. The very position in a state system will be thus capitalized, i.e. economic benefits from the position will be exploited – rent keeping and transactions between owners of positions will occur. The contact between a public institution and private interests creates a short circuit that flares up in corruption. It is obvious that transformation into state ownership does not abolish private interests, but only makes them informal, linking them to the state system and not to success in fertilizing capital.

This is why the system that includes state ownership as a dominant form of ownership is less efficient in economic terms than a system that relies on private ownership. Capital is fertilized only based on personal interest, and not based on public interest that the state should represent and care for. Someone appointed by the state to manage an enterprise cannot escape the designation of being a civil servant. In the best case, which is so rare that it can be considered almost only a theoretical possibility, this person will care of the interest of the enterprise and will transform the assets of such enterprise into capital and will enlarge them.

However, it will certainly happen that the person will care of their prosperity and interests, because any other type of behavior would be unnatural and therefore inhuman. This means that in decision-making, they will be guided by two influences: the fear of losing their position in the nomenclature and their personal, economic interest. Both interests will guide them not to care of the enterprise and its capital, but to do that so as to be able to reconcile both things – the system will drive them to satisfy the party interest or the interest of the group that appointed them to manage the enterprise, whereas the personal interest will urge them to clutch at the rent-keeping.

Both scenarios are detrimental to the enterprise interest – the enterprise activity is becoming more expensive and economic performances, at the general, social level, are declining. Finally, satisfaction of any economic interest entails the activation of assets and their transformation into capital. This is, however, possible only within specific social relationships. If the establishment of such relationships is publically and formally negated and disabled, the very logic of capital will establish them, although at an informal level. Moreover, the price will be high – such models are inefficient in economic terms and capital flows out of them, the assets constituting it deplete and disappear either by way of private consumption or by moving to other markets that do not negate private ownership and rights and relationships based on it.

This is how every 'just' arrangement of an economy and society, which shifts to the state the care of economic interests, ends up again in a private relationship – corruption. On the social plane, instead of an equitable organization of society, we get unjust, unnatural and privileged relationships, whereas the path to degradation is paved on the economic plane. Of two objectives of organization of economic activity in a society – efficiency and welfare of society members, neither is achieved.

I.2.7. Formalization of capital

Hernando De Soto studied the problem of private ownership of assets that were potential capital and the transformation of assets into effective, active capital. In his study, entitled *The Mystery of Capital*,[88] he draws a comparison with assets that have an intrinsic potential to become capital and capital itself, which is born of the transformation of the assets in production and economic processes.

The first step in the process is to clearly define, formalize and legally protect private ownership of assets, from which capital might take its rise.[89] In his opinion, the only way in which capital can emerge is by

[88] Hernando de Soto, *The Mystery of Capital*, first edition 2000.

[89] 'It is formal property that provides the process, the forms and the rules that fix assets in a condition that allows us to realize them as active capital.', and further on: 'The formal property system is... the place where capital is born.', Hernando de Soto, Black Swan, 2001, p. 44-45

formalization of the system of ownership. Once established and protected as someone’s possession, only then could the process of their transformation into capital begin.

De Soto links the success of developed, western countries with the early development of the system of registration and protection of ownership, of every house, every piece of land, and every part of property to the last individual in society. There are multiple positive effects a system of formalization of property brings to an economy and society: Establishment of their economic potential, collecting scattered information, building responsibility in people – holders of property, facilitating exchange of assets, connecting people – growing the market, and protecting business.[90]

Capital in itself is hardly definable. It is easiest to describe it as a potential carried in various tangible and intangible assets for an economic activity.[91] Capital's characteristic of being hardly definable necessitates a clear legal definition. The definition should be devised through the system of registration of ownership so that state, the ‘association for protection”, could ensure all rights arising from ownership, including the freedom of disposal and management.

In a system such as this, private owners of assets, whose rights are protected by the state, by its monopoly of force and other instruments, are free to devote themselves to the turnover of assets, i.e. to transform them into capital and thus boost them, facilitating economic development of an entire social community. Taking care of their own private interest, striving to gratify it by increasing assets, by transformation of assets into capital, without even realizing it and at the same time not really caring about it, they add and contribute to the general economic and social development. Once the entrepreneurial spirit in economy is released – by defining ownership of assets and their transformation into capital, it expands to other segments of society, to the political life, opinions and views, and patterns of behavior. Nil Ferguson has simply put this, by

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[90] *The Mystery of Capital*, p. 47-62

[91] ‘Capital... is... a dormant value. Bringing it to life requires us to go beyond looking at our assets as they are to thinking actively about them as they could be. It requires a process for fixing an asset’s economic potential into a form that may be used to initiate additional production.’, ibid, p. 43

concluding in his book entitled *The Ascent of Money*[92] that the majority of voters in Anglophone countries were at the same time owners of property as well.[93]

In order to validate capital economically, it is therefore necessary to first give it a legal form in the system of norms where it is registered and where the turnover of capital takes place.[94] And it is here where the joining of the social and the economic occurs. The assets which are privately owned come into being as capital, giving birth to certain relations between their owners and those using the assets, thus creating certain social relationships and further developing them. State, an instrument of public interest, *res publica*, protecting private ownership and rights of private owners, protects and advances the entire society.

Relations which facilitate transformation of assets into capital need not be formalized by the state and institutions comprising the state. Anyone who can provide a certain form of institutionalization of ownership in a certain society and who can protect economic processes creating capital and resting on capital can do this. Such institutionalization and protection can be provided by both formal official institutions, but also by unofficial ones. There are abundant examples from countries of the Third World which confirm this. However, this makes the entire process of the emergence of capital, its preservation and growth both time-consuming and expensive, as the process grows more complex, when it comes to relations between the official and unofficial governmental structures.

Thus, capital becomes a cause of emergence of certain social relations and a pledge of their preservation and development; and vice versa, capital itself cannot exist without certain social relations. As much as private ownership is necessary for the rise of capital out of the transformation of assets, certain social relations are as needed, without which capital cannot continue to exist. It is important to emphasize here

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[92] Niall Ferguson, *The Ascent of Money*, published in 2008 (the issue in Serbian: 'Uspon novca finansijska istorija sveta', ПлатΩ, Beograd, 2010)

[93] '... u onim delovima sveta u kojima se govori engleski, ...za stvaranje prvih pravih demokratija zasnovanih na vlasništvu, so oko 65-83% domaćinstava koja žive u kući koja je njihovo vlasništvo. Drugim rečima, većina glasača su takođe i vlasnici imovine.', ibid, p. 234.

[94] '... property... is a concept; it cannot be experienced directly... One can only experience... property by their effects.', Hernando de Soto, ibid, p. 47

that the transformation of assets into capital is possible wherever the process of protection of private ownership is enabled, and its realization in certain social relations.

I.2.8. Temporal inconsistency of capital

Once the presumptions for simple transformation of assets into capital are in place, by a legal system of registration of private property and protection of rights stemming from it, there remains an inconsistency regarding the use of assets in a way that transforms assets into capital. This inconsistency no longer concerns the social setting and its system, but what we have mentioned as the relation between the human logic and the logic of capital.

Speaking about economy in the previous chapter, we have analyzed the organization of economic activities and stated that one of its driving forces is uncertainty concerning future results, uncertainty which is unavoidable, inevitable and an imminent quality of any human activity and endeavor. The effort to overcome it causes formation of organized social communities around economic activities and their further development, by following economic progress.

No matter how much effort we place in overcoming this uncertainty, it remains a constant, which is cumbersome, but at the same time it is a driving force of individual persons and the community to strive for betterment. Looking at the level of individuals, and economic activities of individuals as owners of assets, but also at the level of the entire social community and its economy, it comes down to a dilemma expounded by Keynes. In his *General Theory of Employment, Interest and Money,* speaking about the marginal efficiency of capital, he defines it as a relation between the expected yield and the current supply price of capital-asset.[95] Keynes claims here that the exclusion of expectations from economic analysis concerning the future would inevitably lead to wrong results in theory. [96]

[95] '... the marginal efficiency of capital is here defined in terms of the *expectation* of yield and of the *current* supply price of capital-asset.', Keynes, ibid, p. 88

[96] '... it is mainly through this factor... that the expectation of the future

The expectation of future yield is what could make any participant in an economic processes embrace activities. Moreover, without the expectation, not one person will become a participant in any economic process. It is there where the problem occurs, at the personal, individual level of a potential economic participant, owner of an asset, asset which by becoming capital might produce a yield in the turnover process. The expectation is subjective – to some a certain state of economy will be stimulating enough – to some the same state of economy will prove to be strongly discouraging.

Attempts at rationalization of expectation, its objectification, and definition of parameters which would on grounds of previously gained experience enable more precise and accurate forecast of economic developments and therefore of yield per unit of capital, has ever been the subject matter of economics and its numerous disciplines. Nevertheless, regardless to what extent this activity might be fruitful and what the prospects are that its results are accurate, or not, at the operational level, the level from where economy commences and where it rests – everything comes down to the decision of an individual and the judgment: should the person, to what extent and in what manner, at what moment, actively participate in an economic activity or should the individual refrain from the activity.

The threshold where the decision will be made to capitalize expectations might be quantified in a different way in theory. Keynes himself associates the threshold of profitability with expected yield, making a clear differentiation between the current yield and the interest rate. He brings the level of investments – capitalization of assets at one's disposal in an economy, face to face with the risk determined by two parameters. The first parameter is subjective and depends on personal perception of the economic circumstances of an entrepreneur, or a borrower, if the entrepreneur is about to set off doing business by borrowing money. The second parameter, the lender's risk also contains in itself a subjective element, and this is the moral hazard that the borrower should default on the loan, and only then the objective element ensues – inability to satisfy expectations.[97]

influences the present.', ibid, p. 94

[97] '... Two types of risk affect the volume of investment... The first is the entrepreneur's or borrower's risk and arises out of doubts in his own mind...', and

From the viewpoint of our analysis of emergence, preservation and growth of capital, the rationalization and quantification of determining the threshold at which the decision on economic employment of assets will be made, does not alter the important fact that the perception of the threshold is subjective and that it is contingent on the decision of an individual holder of assets. At the moment of potential engaging in economics, at the moment of employment of assets at disposal, assets being transformed into capital, the holder of assets does not have anything more than expectations; expectations that employment of assets will bring about a yield in the future. At the moment of making the decision to engage in an economic activity, the owner of assets, actually and practically capitalizes their expectations.

The answer to widespread uncertainty, attached to all activities and to economic activities as well, the results of which are tied to the future, thus becomes a personal activity as well, an activity pregnant with uncertainty. To possess an asset might mean that at least the present and the period of immediate future is certain and provided for. The utilization of the asset in an economic activity, turnover of the asset, its investment in a production process mean trading the safe present-day period for an uncertain future. An organized social community, emerged around economy, developed certain institutions and procedures therein. Their purpose is to spur the decision-making concerning economic activities. This is being done either by means of a positive approach, such as the insurance against risks, or by a negative approach, such as tax policies which additionally burden assets that do not have a function i.e. are not capitalized.

However, uncertainty cannot be removed entirely. Provisions can be made for it. Precaution can be taken against some potential effects in realization of economic expectations. However, uncertainty remains. Recently, it might have taken on different forms. Richard Sennett speaks in his work, *The Culture of New Capitalism*,[98] of three challenges posed by globalization before participants in economy: the challenge of time, since institutions are no longer capable of ensuring long-term guarantees,

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further on: '… a second type of risk… which we can call the lender's risk', ibid, p. 93

[98] Richard Sennett, *The Culture of the New Capitalism*, Yale University Press, New Haven & London, 2006 (*Kultura novog kapitalizma*, the issue in Serbian, Arhipelag, 2007)

which might bring an individual to a sustainable feeling of their own identity and existence; the challenge of talent because the pace of changes in economy is difficult to follow by constant working on oneself and by changing activities, which renders such talent irrelevant; the challenge of capitulation, for the previous experience loses importance and might even be a handicap in conditions where it is cumbersome to ensure enough certainty in order to sustain identity and personal advantages and skills.[99]

There is no new response to such a challenge. Undeniably, if someone loses confidence in their environment, where the person performing an activity cannot resolve the temporal inconsistency of capital, then the assets at that person's disposal will disappear untransformed into capital. However, no one else can take over this role in economy, save for the owners of assets be they tangible or intangible. The right response to such a challenge is the same response to the previous challenges that increased uncertainty and it is institutionalization of economic activities.

Formation of institutions with established procedures, which should eliminate risks pertaining to business to the greatest extent possible, increases safety of the entire environment for economic activities. Uncertainty is more easily defeated and the inconsistency resolved through institutions – the inconsistency resulting from the difference between the current, sure enjoyment of certain assets and the less safe investment of such assets with expected yield. Special institutions pertaining to the capital market were developed by spontaneous activities of participants and later on by involvement of state and the today's activities of supra-governmental institutions for the purpose of overcoming this inconsistency of capital, as much as it is possible, since it has been impossible to overcome it absolutely.

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[99] Ibid, p. 9-10

MARKET ACTIVISM

I.3.1. Market as an environment

The market is at the borderline between the economic and social concept. It links them, but also enables a clear distinction between the two. What lends an economic character to a market are economic processes carried out there, relating mainly to economic trends. In this regard, a market provides for an environment and conditions where different goods and services may become capital and develop further as capital.[100] The social nature of a market is reflected in the fact that all activities are implemented there between individuals and groups of people, institutionalized to a greater or lesser extent.

Market activities are indeed of economic nature, but as it is in cases when people usually group, they may not be classified in one area only, no matter how complex and polysemic that area is. Relations of different nature are also established among market actors, these relations are not primarily linked to economic activities. However, they would not have taken place but for the market and groupings of people owing to particular interests in the market.

Over the entire course of its development, economic theory has dealt with market developments, with what should be provided in the market to enable the occurrence of particular phenomena, as well as with what would be indispensable to preclude certain phenomena. Even the very market processes become stripped bare to the extremity deprived of those who implement them and completely separated from them.[101] They

[100] See the previous chapter on capital.

[101] '... What economists are only interested in is price formation and not the market as a *sui generis* institution.' furthermore: '... economists are only interested in setting of market prices', Richard Swedberg, *Principles of Economic Sociology*, Princeton University Press, 2003, cited according to the Croatian edition: *Načela*

thus become a range of actions, without clear motives, i.e. centered on one motive only: profit – for the purpose of further augmentation of economic activities. The existence of other and different interests, such as improved quality of life or security in any form, remained outside of the focus of interest of economic thinkers.

Moreover, economic thought strove for a long time to sever any link between what was going on in the market and anything else apart from the activity focused on increasing capital, not even profit if observed as something to be earmarked to satisfy other needs, apart from economic ones. In the best case scenario, such behavior of economic actors would be classified under personal consumption.

It was believed that market structure, differences in institutions that market processes were implemented through differences in the processes from one market to another and finally the very conceptual definition of the market would have distracted attention and resources from what economics should deal with – the very effects of market developments. These effects depend only on market factors, on confronting supply and demand for instance, whereas the cultural element should be disregarded not to obstruct the essence of the research.

Milton Friedman underscores, clearly and unambiguously, that the essence of the market where competition is prevalent (unlike its segments where the state or monopolies of a different kind are dominant) is its impersonality. He underpins his arguments by saying that no market participant can undertake anything that would impact significantly on operating conditions of any other market actor. That is why the prices set in such a depersonalized market are accepted by everyone – not as something imposed, but as something natural and implied.[102]

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ekonomske sociologije (*Principles of Economic Sociology*), CID Podgorica and MATE Zagreb, 2008, p.104-105

[102] ‘There is no personal rivalry in the competitive market place. There is no personal higgling. The wheat farmer in a free market does not feel himself in personal rivalry with, or threatened by, his neighbour, who is, in fact, his competitor. The essence of a competitive market is its impersonal character. No one participant can determine the terms on which other participants shall have access to goods or jobs. All take prices as given by the market and no individual can by himself have more than a negligible influence on price though all participants

Other directions of economic thought do not contribute too much to an understanding of the market category either. They primarily deal with what is happening in the market. The mainstream of Marxism accepts the market as one more phenomenon serving to determine particular social relations. At first sight, that implies a social connotation in observing the market, but only on the surface. The market is not established as a social phenomenon, while theoretical explanations relate not to market processes as to the elaboration of their detrimental nature and the need to overcome such situation by taking a social action.

Before Marx, Adam Smith in his book *The Wealth of Nations* paid special attention to institutions creating the legal framework for market activities. He also made a clear distinction between the labor force market and other market types. He formulated the first, consistently defined principles based on market actors' activities ('invisible hand of the market'). However, he did not define the market itself.

Keynes arrived at his theory by spotting the imperfections of the market as a mechanism for achieving equilibrium in the economy – between supply and demand and within particular markets, for instance the labor force market. The conclusion that he reached in his analysis was that the state should, by all means, be more engaged in eliminating such disequilibrium. His conclusion was, in a certain way, controversial as it would mean suspension, if not permanent abolition of the market in some segments of the economy.

Furthermore, he showed on the stock exchange example that following trends is based on guessing the investors' reactions rather than on the analysis of economic factors. However, the introduction of this undeniably social element does not mean its further examination, but rather an escape from it and once again, the emphasis on the need for the state to interfere is *deus ex machina* that would always know which action is indispensable in each particular moment and any particular economic segment. This is how, by escaping from the social concept, we reach a social political institution – the state, as the solution to problems caused by interference of the social concept in the economic sphere.[103]

together determine price by the combined effect of their separate actions.', Milton Friedman, Capitalism and Freedom, The University of Chicago Press, Chicago and London, 2002, p. 119-120

[103] John Maynard Keynes, *General Theory of Employment, Interest and*

Not even more contemporary critics of neoliberalism contribute much in this regard. Joseph Stiglitz in his book *Economics of the Public Sector* analyzed various phenomena relating to the market and its efficiency – for instance, Pareto-efficiency; he dealt with specialized markets, such as the futures market and with a special sub-phenomenon within it – its inefficiency. There are no analyses of the market itself, not even at the general level or the level of individual, specialized markets.[104]

Economic thought was apparently much more interested in market developments than the market itself. The market was considered to be something given, implied, almost at the level of the ambient. In the *MacMillan Dictionary of Modern Economics*, the definition of market is short and succinct – a market is 'any context where the sale and purchase of goods and services are performed'.[105] Methodologically speaking, this definition is a tautology. To reiterate, it is obvious that what was examined was not the market as a phenomenon, but only the elements implied by the phenomenon.

I.3.2. Market as a part of society

In an effort to define the market as a phenomenon, the first assumption is that it is created and based on a particular activity of people. This is such a wide concept that it actually says nothing. Everything that social sciences deal with, including economics, derives from human activities. The nature of these activities and the manner of their implementation should however, as we reveal them, lead us to define the concept of the market. However, the starting assumption must not be disregarded because the fact that the market is composed of

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Money, BN Publishing, 2008, see also: Richard Swedberg, *Principles of Economic Sociology*, Croatian edition, p. 112-113.

[104] Joseph E. Stiglitz, *Economics of the Public Sector*, Serbian edition: *Ekonomija javnog sektora*, Faculty of Economics, Belgrade 2008. It is perhaps even more surprising that this book, focusing on economics of the public sector, does not deal with a more precise definition of the state as a phenomenon, but only gives the number and some types of agencies that constitute it (in the USA).

[105] David W. Pierce (General editor), *MacMillan Dictionary of Modern Economics*, Palgrave MacMillan of Houndmills, 2003, cited according to the Serbian edition: *Mekmilanov rečnik Moderna ekonomija*, Dejvid V. Pirs, Dereta, Belgrade, 2005, p. 509.

human activities and is therefore a social phenomenon, lends to the market a mark that should not be disregarded, as such mark will leave an imprint on market developments in minute detail.

At its core, each market consists of a group of people. Their grouping is motivated by satisfaction of particular interests, or more precisely, the very satisfaction of particular interests brings people together, establishes relations among them, and the plethora of such relations constitutes the market. The particular character of these interests is linked to the economy, the economic activity, but not only to it in the narrow sense. There are whole sets of other interests, either those directly deriving from it, or those that cannot be satisfied without it, which also results in people establishing particular relations among themselves in order to satisfy their interests.

Satisfaction of interests makes the market active all the time. It imparts to it its key feature – activism. Economists of classical economics would argue that market supply and demand range from establishing equilibrium among them, where after the exchange is further achieved on that equilibrium point. The difference among individual interests, even when they are objectively identical makes the above equilibrium only a theoretical assumption – a state to be reached possibly, if all other factors existing in the market were disregarded.

However, the equilibrium is not reached as market movements oscillate above and below it, guided by the individual experience of interests and manners of satisfying them. Ways of satisfying interests would spur the shaping of different market strata, different specialized markets, different institutions for the market as a whole, as well as institutions for particular strata and specialist markets.

This is how we arrive at a determination of the market as a social phenomenon, a *sui generis* organization which could be more or less institutionalized; consisting of actors grouped in different market segments according to the manner they satisfy their interests. Interests that represent the *spiritus movens* of market participant activities are linked to the economy, directly or indirectly, and cannot be satisfied, judging by their very nature, in a one-off manner, but in the permanently active process of the indispensability of repeated attempts at the best possible satisfaction. This gives the market its constantly active nature, making of it a complex structure of active processes led in its institutions by market participants.

Market participants, on the other hand, do not exist only in the market. They are linked to it while participating in processes of satisfying their particular interests. However, they exist and are active even outside of the market. Both as individuals and corporations, they are, together with the whole market, a part of a society and social structures. They struggle in the market for economic interests, but they also satisfy their social interests. The activities they undertake in the market are also reflected on society, and the position they establish for themselves in the market also changes their position in society.

The market is immersed in the overall market structure where other interests dominate, apart from economic ones. The extent to which members of a society will also be market participants depends on what and how great interests they will be able to satisfy in the market.[106] On the other hand, this depends on the organization of the society, the political system that may be more or less inclined to the market, and therefore on the market's significance for the society and all its members.

In a tribal society, as explained by Max Weber in his work *Economy and Society*,[107] the market appears as a phenomenon sporadically, when two tribes meet. There is no institutionalization or exchange within a social community. The market is experienced as something foreign and external relative to the community. It is only with the further development of the social community that special strata within the society are established, whereby the trade stratum, by its very existence, is linked exclusively to the exchange, which results in the creation of the local market centered on that activity, i.e. the creation of a market within the community. This enables its initial institutionalization.

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[106] Richard Swedberg suggests in his book *Principles of Economic Sociology* that the link between the market and society may be measured by five parameters: a) voluntary approach to the market and use of its processes; b) the degree of the dependence of some society members on the market and market developments, c) the type of interests (political, economic…) to whose satisfaction some society members give priority; d) economic power, implying the possibility that other actors are induced, without force, to a particular action in the market; e) the interest of political actors is directly dependent on the quantity of resources traded in the market and thus on the overall dependence of society on the market. – Richard Swedberg, *Principles of Economic Sociology*, Princeton University Press, 2003 (Croatian edition: *Načela ekonomske sociologije*, CID Podgorica and MATE Zagreb, 2008.)

[107] *Wirtschaft und Gemeinschaft*, first edition: 1922.

Own institutions were created in the market when the first specialized markets and fairs as markets for traders were shaped in the Middle Ages. Along with institutions, relations among traders[108] were formalized and legally defined, which increased the safety of operation, but also additionally strengthened the traders' position within respective social communities.

Traders also received additional protection from local rulers, certainly on account of the tribute they paid to them from their activity.[109] However, this meant that the state secured the market by particular measures. Increasing the coverage of market protection, both in territorial and quality terms, along with the enlargement of territories by merging different areas in national states, and the change of the character of institutions making up the state, created a framework where the national market was shaped.

Again, the status achieved by market participants, this time not only traders, impacted the market structure, the distribution of power within institutions and formation of particular social processes and state policies. The first world market was formed already at the turn of the 20th century, only to once again collapse to national levels, rising to the current global market in the second half of the last century.

At that level of development, the market was shaped under the influence of larger and larger international corporations, but it also enabled the corporations to operate in a wider and wider territory, under all possible categories of specialization. The global market has its institutions as well – from the World Bank and the International Monetary Fund, through the World Trade Organization to the International Organization of Securities Commissions, which strive to harmonize operating conditions in an increasing number of national markets, making of them only parts of the global network.

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[108] *Lex mercatoria* in Latin, Law Merchant in English.

[109] In the period of the Serbian Despotate, in the late 14th and early 15th centuries, to engage in trade, a trader had to obtain a special approval – a 'diploma' of the Despot's office, providing him not only with the protection of the Despot's armed officers, but also the physical approach to the square in the Belgrade Danube port that served as a gathering place for traders, or a stock exchange of the time; moreover, the Despot's "diploma" also provided the trader with international protection as it was recognized as a travelling document and was accepted by other local rulers. According to: Marija Ilić-Agapova, *Ilustrovana istorija Beograda* (*Illustrated History of Belgrade*), edition of the City of Belgrade Library, Belgrade, 1933

I.3.3. Network structure of market

The market thus changed the social environment, and market interests triggered a change in the social structure and social institutions. An obvious example was the appearance of a special layer of traders, reflecting the spread of economic activities and the rising need for the exchange of goods. Velimir Bajkić, a professor at Belgrade University between the two world wars, explained in one of his articles, in a Weber-like manner, the reasons and importance of the appearance of a special stratum in a society dealing with exchange.

Furthermore, for that very reason, he considered the historical period when that happened a step forward from barbarism to civilization. Exchange entails communication that directs those who devote themselves to exchange and base on it their own existence, i.e. traders, to engage in an activity that pulls down barriers and establishes links among different communities. The path from the trade activity, through trading places to cultural centers represents a natural path and a logical development. Therefore, the market is much more than the 'gathering point' on trading paths – it is the basis of cultural and other forms of social progress.[110]

The reverse is true as well – dying trade and extinguishing markets led to dying cultural centers and even the disappearance of entire peoples and states. The example of traders and the development of their activity may be followed from the appearance of the market to date, with all changes and influences exerted by traders on the economy, the economy on them, and through them on the society, resulting in the reversal of the influence, in a somewhat different form, on the economy.

Today, theorists dealing with the scientific discipline exploring the market as a social phenomenon – economic sociology, and the above

[110] 'The exchange of goods that drove the transport of people is the landmark event marking the shift from barbarism to civilization. The exchange entails one's whole life and thus develops the profession of a trader who, at such early times, still has no work within the community, but represents a live link between different… they [people] need him as a mediator. He is the only link among them, he is the only one who knows several languages, various customs, transfers the achievements of one community to another. Trading paths are at the same time the paths of culture. If the geographical position was favourable, then the gathering point of those roads became the cultural centre for a bigger area, over a longer period…', Velimir Bajkić, *Izabrani spisi* (*Selected Papers*), Official Gazette, Belgrade, 2009, p. 440

reflexive mechanism between the market and society, have explained differently the way the market functions. If they have anything in common it is that the supply-demand relation as a cause of everything to be explored in the market is of no concern to them. Moreover, they believe that a market functioning on that basis cannot be properly, scientifically explained.

The starting points for their market research are interests and stakeholders in society.

Matching interests will enable the grouping of actions of those striving to satisfy those interests. Grouping will lead to the creation of different market structures that may take the form of institutions, once their functioning is formalized and subjected to prescribed procedures.

Relations among representatives of different groups will be of a market nature, i.e. they will strive to the state described by Friedman in the quote on market impersonality –market relations in the narrow sense. According to Brian Uzzi, in addition to these relations, there will also be relations of a special type, established among representatives within one group, which he calls 'embedded' relations. They rely on trust within a group.[111] It is worth noting that those are not social groups, created due to social solidarity, for instance due to the existence of minorities. Those are groups formed around economic interests. Uzzi analyzed New York companies dealing with ready-made clothes.

There is no market that relies only on impersonal market relations, or only on embedded relations. It is always a combination of these two types of relations and ties, because embedded ties, without the market ones, would lead to a cartel, while it is impossible to establish market ties due to the social nature of the market, i.e. the fact that the market relies on the activity of people with a natural inclination to make groups in order to achieve a particular aim.

Somewhat earlier, Wayne Baker showed through analysis of the securities market the simultaneous existence of at least two network markets with different degrees of social integration. Smaller networks have denser and more frequent contacts and links among their members,

[111] Brian Uzzi, *Social Structure and Competition in Interfirm Networks: The Paradox of Embeddedness*, 1997, cited according to: Richard Swedberg, *Principles of Economic Sociology*, Princeton University Press, 2003 (Croatian edition: *Načela ekonomske sociologije*, CID Podgorica and MATE Zagreb, 2008, p. 125-126.)

while contacts and links among wider network members are less frequent.[112] The securities market is an obvious example of a narrower network consisting of brokers, whereas a wider network would be made up of all other market actors trading in securities through brokers.

Brokers communicate more frequently and are focused only on what concerns securities, and their information is therefore timely and of good quality. Other market participants, grouped around different interests and not engaged only in stock exchange investments, do not exchange information only on the securities prices and relating trends. They receive information indirectly, through the media and from brokers, and make their business decisions based on such information.

It should be noted that this is not information asymmetry, i.e. that brokers have different information than clients. This is simply not possible with the current capital market regulation and the level of media development, or it is possible at the incident level (which is severely punishable). However, the manner of accepting information and reacting to it will be different in the case of a broker and someone whose primary activity is not securities trading.

This brings us to the conclusion that the price of a security, in this example, is not the product of an unambiguous action of market participants, but of a more complex activity established among members of a wider and narrower market network and within such networks – in this case between brokers and their clients. Baker concludes that social structural patterns dramatically influence the direction and size of price volatility.

According to Uzzi, Baker and other theorists of economic sociology, the market is not less efficient due to the social structure nor should the groupings in the market be observed as an introduction to the discrimination of some groups against others. The voluntariness of participation is what is implied with every market participant. Force of any type annuls the market which can function only on the basis of the individual perception of interests and the individual selection of instruments for the satisfaction of interests.

[112] Wayne Baker, *Markets as Networks*, 1981, cited according to:Richard Swedberg, *Principles of Economic Sociology*, Princeton University Press, 2003 (Croatian edition: *Načela ekonomske sociologije*, CID Podgorica and MATE Zagreb, 2008, p. 124-125.)

The market structure only means that there are several ways to satisfy particular interests, which increases the possible efficiency of activities undertaken in the market. If that is not possible within the same market group, a step forward will be made to representatives of other groups. More precisely, a focus will be placed on the concurrent satisfaction of interests of all potentially interested groups and their members.

Public offering of a security gives everyone an equal opportunity to buy it. Whether it will be sold within a denser brokerage network or bought by someone from a wider market network depends on the estimate of market actors. It is assumed that other brokers will be more inclined to buy it, provided equal conditions and information is provided to everyone, because it is their core activity and because they deal with securities trading and live on it.

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The market structure interpreted as a system of different, networked groups, with intertwined ways of satisfying their interests, gives a picture that can offer many more answers on the way of market functioning and the achievement of particular effects in it. Within such a structure, for instance, it is easy and logical to explain and accept the view of George Soros who introduced the notion of 'reflexivity'[113] in the analysis of financial market trends. Market trends, particularly in times of a crisis, are more easily measurable in such structures.

Understanding the market as a social phenomenon is particularly important for its segment that is, in the period between crises, explained almost exclusively by mathematical models – the capital market. The Black-Scholes model for option valuation is an example of the lack of success of an almost perfect mathematical model due to social circumstances, i.e. variables deriving from the social and political sphere, which is why they do not belong to a mathematical model.[114]

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[113] George Soros, *The Crisis of Global Capitalism*, Public Affairs, New York, 1998

[114] For more detail see: Niall Ferguson, *The Ascent of Money*, 2008, Serbian edition: *Uspon novca, finansijska istorija sveta*, PlatΩ, Belgrade, 2010, p. 319-332.

It should be borne in mind that capital market developments cannot be adequately pondered without understanding the place of the capital market in the overall economic and social system. The way social structures affect the capital market and the forms of such effect will also derive from that position. Last but not least, only with such understanding is it possible to gain more worthwhile knowledge about the capital market importance for the society overall and its impact on the social structure and spheres where it exists, where it is organized and where it functions.

PART TWO

CAPITAL MARKET

II.1.1. Characteristics

The capital market enjoys a special position within the structure of the market. It occupies such a distinct position owing to special features of its subject of trading, as well as the special institutions and methods of operation utilized in the market. As regards other parts of the entire market, its distinctive features and characteristics might be compared only to the labor market, whose subject can be described as being as special and distinct in relation to what the subject of turnover is, in the rest of the market.

The subject of turnover in the capital market is capital in its pure form, devoid of manifestations of an asset, commodity or a service. Once it reaches the capital market, capital has already been materialized, it is not merely a potential anymore, a dormant value in an asset as Hernando De Soto describes it.[115] An asset from which capital has emerged, has already found its way to turnover and it has established a certain relation, be it the capital-relation or debt-creditor relation. The subject of trading around which the capital market is organized is therefore derived from a primary relation. This primary relation could be proprietary, if it stems from an investment in a company or debt-creditor relation, if it has been established on the basis of a loan. Assets have already been transformed into capital: money or an intangible good, or equipment have already become invested, and therefore put in the processes of turnover, and transformed into capital.

It is necessary to surmount yet another level, from the investment to purely manifested capital in free circulation. Capital is hard to materialize in everyday life, it is created, and it exists only in turnover,

[115] 'Capital… is… a dormant value.', Hernando de Soto, *The Mystery of Capital*, Black Swan, 2001, p. 43

only when it is active. In order to trade capital independently of assets to which it is tied and from which it stems, it ought to be expressed in a recognizable and a universally measurable way. It should be standardized and formalized. The relation created by the investment of assets and their placement into the process of turnover is established as a norm, it is standardized and formalized – it assumed a form of a security. Having the form of a security or a standardized futures contract, capital lives and circulates in the capital market. The standardization and the formalization have raised it to a level which is derived from the original relation; capital is abstracted from it, and partly liberated from it.

This is the process which bears an inconsistency, because in this way, capital becomes idealized as its material liberation, as a security or a contract and approaches a featureless form, the form which money has, for example. In this way it is possible to circulate it independently or almost independently of a tangible asset, and of the concrete relation from which it has originated. Moreover, idealized in such a way, it pursues its economic life in turnover of securities, validating itself. With every concluded transaction, it realizes its value again and again.

II.1.2.Some effects of the capital market

Imparting a measurable and, therefore, an easily tradable form to capital facilitates its great mobility. It facilitates and alleviates, to the utmost, what has originally enabled its emergence – the simple and constant placing into circulation. The larger the mass of capital being formalized and made featureless in the capital market, the greater the potential for its quick and efficient allocation in the economy. Therefore, the capital market's effects on the economy are more marked.

Niall Ferguson shows in his work *The Ascent of Money* that the absence of a capital market is one of the reasons for the sluggish Chinese economy in the period preceding the end of the twentieth century.[116] The development of a capital market imparts numerous advantages to an economy and its participants. Primarily, it is about surmounting two

[116] Niall Ferguson, *The Ascent of Money*, 2008, the issue in Serbian: *Uspon novca, finansijska istorija sveta*, PlatΩ, Beograd, 2010, p. 287

fundamental inconsistencies that are inherent in capital: the one that stems from its connection with the personal property, and the one stemming from the temporal dimension necessary for its turnover.[117] There is no other institution capable of resolving it in a simpler, long-term and more efficient manner.

The capital market enables the middle stratum in society to emerge and grow, offering retail investors access to large economic enterprises. In this way, the network of private property spreads, having a stabilizing effect on every society. Once the middle class has risen, it exerts constant pressure for democratization of society. For example, the middle class toppled the dictatorship in Chile; and measures pursued by proponents of the Chicago school of economics, which contributed to the expansion of the capital market, had fueled the growth of the Chilean middle class.[118]

It should be noted, too, that capital markets help curb corruption through the transparency of trading, symmetry of information and the public's exposure to the key protagonists. The capital market in its developed form links the most important part of economy directly with society. This connection enables each member of society to have a share in responsibility with a minimal investment, and a share in success of the overall economy in which he participates; and this fosters the proprietary democracy without which there is no stable political democracy.

[117] We have already expounded on these inconsistencies in the previous chapter entitled *The Capital Activism*.

[118] For more details, see Niall Ferguson, *The Ascent of Money*, p. 212-219 (Serbian edition used).

SHAREHOLDING

II.2.1. Formalization of transactions

A transaction comprises certain important elements: parties which take participation in it, conditions under which it is concluded, the terms for its implementation and execution, its value and its subject. Any note about a transaction represents its formalization. Once it is formed – on clay tablets or in an electronic record – it can become a subject of another secondary transaction. Formalization also requires at least the most fundamental degree of previous institutionalization, which arranges general conditions and manners for conclusion of business transactions.

Formalization and creation of conditions which support such forms of business transactions precede the capital market. For the capital market to emerge, a certain depth of the market is necessary. It is achieved by frequency of transactions, with larger and larger number of business transactions concluded in a certain way. This facilitates standardization of such transactions and the additional building of institutions, which in turn will support it by their procedures.

Therefore, a capital market will not form and grow amid scarce conclusion of contracts by which one party to the contract gives money to the other party, to be used in a certain manner and increased. It will be established by a large number of contracts concluded in a similar or equivalent way which will render them mutually exchangeable. The contracts themselves will represent a value, derived from its subject, the contracted asset, and the relations of exchange will be established on that base.

The creation of a capital market is preceded by separation of capital from the underlying transaction and its expression in a special, separate form. To emerge and develop into the size and form we recognize today, several other processes must precede the capital market. Shareholding is one of these processes, derived from the capital-relation, and it is by far the most important for the emergence of the capital market as a separate segment of the entire market.

II.2.2. Pooling of capital

Shareholding can be seen, in its broadest sense, as a pool of capital in a company. There is nothing amiss with such an interpretation. It is as true as it can and should be for everyday use, without going deeper into the reasons for the creation and importance of shareholding.

However, these reasons and their very importance distinguish shareholding from the other pools of capital we encounter on a regular basis. Pooling occurs in employee consortiums, in the course of privatization; or in acting in concert in order to conduct a company takeover; pooling even can be a one-time arrangement in the form of a commercial enterprise; one can also collectively invest in an investment fund or in a limited liability company.

Shareholding is not just any form of pooling in capital, and to grasp it more deeply, we must define it more accurately by making a differentiation from the other forms of pooling. We will examine it in its most advanced form, where all of its features become distinctly prominent – the form of an open joint stock company. At first glance, it is clear that shareholding is about pooling capital in order to carry out an activity, and consequently earning a share in profit. This, however, still does not differentiate shareholding from the other forms of collective investing, excepting, perhaps, non-governmental organizations.

II.2.3. Interests and confidence

Joint ownership needs to overcome two forms of interest, the first being individual interest. This seems a controversial contention at first glance, since the notion of shareholding stems from individual interest in any story about capital and its enlargement. Nevertheless, the collection of individual interest in a joint stock company gives much more than a mere sum. It produces a new, synergistic interest. Where does the one motivating interest of an individual shareholder go? It motivated the shareholder to join the other co-founders of a joint stock company in the first place. So, what keeps individual shareholders together in a joint stock company, when their individual interests fuse into one, common interest of a company?

Trust is the starting point in the process of overcoming the individual interest for the purpose of a synergistic corporate interest. Were it not for trust, there would be no economy as we know it today: there would be no loans; cyclic production would be impossible to organize; commodities could not be transferred from market to market. Likewise, it would be impossible to form a joint stock company.

Every joint stock company rests on trust. At a minimum, personal trust in the key co-shareholders was the basis for formation of the first individual commercial enterprises. However, in order to sustain them, it was necessary for the personal trust in the integrity of the other shareholders in the company to evolve into a new dimension.

Evolution of personal trust into corporate trust occurs by its institutionalization. Institutions – from the state and its regulatory bodies to the self-regulatory organizations such as stock exchanges – stand as authorities behind the actions of joined individuals and the ones who manage the pooled capital. They provide guarantees, using sanctions when needed, that interests of individual shareholders – investors in joint stock companies – will not be violated.

Then, personal trust gives way to trust in the corporation itself and its mission. New shareholders join the company believing in its business policy and expecting to earn a profit proportionate to their investment.

II.2.4. Temporal limitations on interests

Secondly, shareholding had to overcome temporal limitations on interest. Partnerships that merchants made from the Ancient World, through the Middle Ages to the Modern World had a one-time character. Likewise, Phoenicians and Dubrovnik and Kotor traders alike gathered in trading partnerships in order to journey to distant markets. Returning from those markets, they would sell the goods, and once the profits were divided, the partnership would be dissolved. Their partnerships remained personal, related to the trading person in question, and did not create a permanent synergetic interest.

The trading interest – the interest of those who earn money by turnover of other peoples' money and goods – induced a prolongation of commercial partnerships made for individual, one-time businesses. The oldest material evidence about these trading companies can be found in the Region,[119] in notarial documents of medieval Kotor. One of the documents, for example, dated February 4, 1333, reveals how a certain Tripun Buće and Gradislav Gorni 'set up a trading company'.[120] The document states the exact amounts both of them had invested, including a provision saying that 'the profit and loss shall be divided into halves, and a final reckoning shall be made by the next year'.[121]

The next natural step was to hold the pooled capital together in its employment for the initial purpose, immediately following payment of profits from the previous engagement. In this way, turnover was accelerated and the capital itself became a new entity – a joint stock company. There are documents of medieval Kotor public notaries that testify about payment of profits, and only the profits, per each trading venture.[122] This should signify that the principal remained untouched for the purpose of further business, though there is no written evidence of the time to support this. There also is no evidence of the existence of an organization similar to modern joint stock companies. Several centuries were to pass until they emerged, and that did not happen in the same Region.

Within the contemporary meaning of the term, the first joint stock company is generally believed to be the Dutch East India Company.[123] Its

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[119] South-East Europe

[120] '...facimus societatem ad inuicem...'

[121] '...quorum de bono et minus bono medietas est super me et medietas super eum, de quibus obligor sibi facere rationem usque ad unum annum proxime venturum de presenti viagio...'

[122] E.g. 'Zlatar Pobrat received from Tripun Buca 150 perpers of profit from this voyage; two-thirds of the profit and loss shall be attributed to him, and the third to Tripun, and the reckoning shall be made the following year. Pobrat's son Sabe agrees.', dated March 1, 1333

[123] Vereenigde Nederlandsche Geoctroyeerde Oostindische Compagnie (VOC)

formation illustrates how the trading interest had succeeded to create from a futures contract a permanent pool of capital, a company with an unlimited period of operation, by surpassing temporal limitations. The first companies set up in the Dutch provinces for the purpose of doing business east of the Cape of Good Hope had limited duration. Even after the unification of the provincial companies for the purpose of pooling capital into a single large United East Indies Company in 1602, the company had still been more of a merchant enterprise with limited duration,[124] than a lasting company. Investors had in their hands a document which attested to their investment which would be paid out with due profits, after the expiration of a certain number of years – not earlier than ten — and the document explained that investments would not be disbursed,[125] but dividends only, when business operations allowed it. The document attesting to the investment became at the same time a proprietary deed confirming the permanent investment in a merchant enterprise – a share.

This is how the one-time interest was left behind by the very logic of doing business. It evolved not into a time-limited interest, such as with investing in bonds, but into a standing, perpetual interest. Once more, a shareholder invests in stocks because of his belief in the company's mission on the market. The shareholder does not expect from it a clearly defined interest, realizable in a certain time period and under strictly defined terms. The shareholder expects from the company whose stocks he has bought, a constant, perpetual performance of activities, which brings a profit, though a profit not defined in the sense of an interest payable on holding a bond.

Thus, for shareholders, investors in shares, the focus is on the performance of activities. The interest becomes secondary, a derivative of the activities. In this way, it might even happen, that shareholders vote during their meetings in favor of reinvesting their profits, instead of opting for payment of dividends.

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[124] Twenty-one year, with the right of shareholders to demand return of the invested money after the first ten years.

[125] The reason was the lack of cash as well, and not because someone wanted to plan and execute formation of the new type of equity companies, intended for large and challenging business enterprises. Thus again it was confirmed that simple and individual trading interest, in its gratification, creates conditions for general betterment.

Surmounting both of the interests that lead to shareholding, the personal and the one-time interest, is a mutually conditional process. The same institutions guaranteeing protection of the interest of individuals in a joint stock company, thus creating a new corporate interest, guarantee market stability as well. This dual role enables expansion of the business horizon, while the interest transforms from the one-time, through recurring, and into a perpetual interest.

II.2.5. Ideal share

Hence the real individual interest, the interest created by investing in one-time commercial business transforms into something else. We have seen that a joint stock company's business activity and the potential for profit motivate investors. The investment in the form of a share is no longer, for example, a single, specified part of a cargo in a ship returning from a distant market. It becomes a part of the complete, total company capital, serving the purpose of its core business activity. Therefore, a share and the unit of ownership it denotes, becomes an ideal component of the joint stock company capital, which cannot be linked to real and legal relation of owning an item of a company's property. The share becomes a symbol of ideal value, completely depersonalized, and separated from the person-investor, by all the inherent features thereof, save for the fact of owning it.

The share then is easily separated from its holder by passing ownership (*traditio*). Its value is detached from the value of the company capital it represents, in the course of trading. Hence, the stocks of a company in financial distress sometimes grow in spite of the company's difficulties. They become a commodity, easily exchangeable and tradable. They behave exactly like that in legal transactions – with all the characteristics of what legal literature calls *genera*. The share thus becomes a commodity of general character. It had been such from its inception, as well. When issued it represents a part of a capital which has its value, but still does not belong to anyone, it being disassociated from any person. The share is a depersonalized part of capital both by its origin and turnover.

II.2.6. Anonymity of shareholders

This explains the name for the joint stock companies derived from the Latin legal systems: *sociètè anonyme*. The legal regulations of the matter based the definition of joint stock companies on this notion from the beginning. Napoleon's *Code de Commerce*, from which stem all the world's regulations on shareholding to the present day, clearly demarcate 'anonymous companies' as one of the three forms of company organization. By describing them in detail, the Law first provides their negative definition, i.e. it first says what these companies are not – they are not defined by a name of any of the founders.[126]

This provides a legal confirmation that a company with its capital is above an individual investing in it. It clearly delimits individual from corporate, corporate being placed at the farthest possible point from individual, when it comes to joint stock companies. This led to creation of a norm that a single owner – shareholder – could not be a bearer of the total corporate interest. Individual interests retreat in the face of the corporate one. Personal interest of individual shareholders fused into a synergetic corporate interest. It does not cease to exist. However, guarding it becomes impossible without looking after the corporate interest.

Defining a common resultant of these interests on a daily, operational basis is rendered impossible by dispersion of ownership interests and dispersion of shareholders. It would not be technically possible. Owners – shareholders – have been left with an option to protect the overall achievement of their individual interests through attainment of the corporate interest.

Protection of corporate interest is entrusted to a company's management, separating ownership and management. The division is not diminished by the fact that the management is appointed and de facto, hired by the shareholders, to run the company. Shareholders may have their say about the management of their company in two different ways: at shareholder general meetings or by a principle of referendum, on the stock exchange – by buying and selling shares.[127]

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[126] Code de commerce, a. 29.: 'La société anonyme n'existe point sous un nom social: elle n'est désigné par le nom d'aucun des associés'.

[127] This entire relation is further complicated taking into account the fact that

II.2.7. Limited liability of shareholders

Anonymity of a joint stock company brings about a logical consequence, which is also used in legal definitions of joint stock companies. Since owners of a company are anonymous, they are represented only by shares – a purchased part of the equity. Hence their accountability for business operation of a company cannot be expanded beyond that portion of the capital expressed in shares. Each shareholder is responsible for company's operation to the extent of the amount of his investment.

The French Commercial Code clearly states this by saying that those united in an anonymous society are not responsible for a loss, but only for their own stake in a company.[128]

Serbian legislation embraced this reasoning likewise, governing the matter for the first time. Section § 31 of the Commercial Code of the Princedom of Serbia,[129] specifies: *'дружство безимено (акціонерско) непостои подъ заєдничкимъ именомъ, нитъ є означено именомъ ма когъ участника, него му се дає име по предмету предузећа'* ('an anonymous company (joint stock) shall not exist by a mutual name nor shall it be denoted by a name of any of its owners, but it shall bear a name according to the company's purpose).[130] And further on in section § 34: *'Участници овогъ дружства одговараю за штете дружствене само са своим улогомъ'* ('Owners of the company shall be liable for losses solely by their respective stakes.').

The Commercial code of Slovenia and Dalmatia, the then parts of the Austro-Hungarian Empire, passed two years later,[131] in Section 3 'On joint stock companies', determines anonymity of joint stock companies in

management is comprised of a set of individuals with their own interests, not necessarily matching the interests of shareholders, and even the corporate one. Nowadays, reconciliation of these interests, their placement into a functional whole is a task of corporate governance as standardization of the interest game of different interest groups within a company.

[128] Code de commerce, a. 33.: 'Les associés ne sont passibles que de la perte du montant de leur intérêt dans la société'.

[129] It was enacted on 25 January 1860

[130] For example: trading joint stock company, joint stock company for foreign trading...

[131] It was enacted 17 December, 1862.

a somewhat different way: ‘A trading company is a joint stock company when all partners in trade participate solely by their share of ownership, without being personally responsible for the company’s liabilities.’ It underscored what came as a logical consequence of anonymity of a joint stock company, that shareholders could not be held responsible for its operation by anything higher than their respective share of ownership represented in shares.

These two traits of joint stock companies, the first of which can be regarded as *differentia specifica*, and the second one as its logical consequence, are merged by a definition of joint stock companies found in the Law on Joint Stock Companies of the Kingdom of Serbia. Article 1 thereof, sets out: ‘A joint stock company shall be the one formed with its principal predetermined and divided into parts of equal value – shares – wherein shareowners participate and are held liable only by their shares of ownership.’ Therefore, first the capital is issued, and then, later on, it is assigned a name by purchase of shares. Those who buy the shares, those who give a title to the shares, are to be held liable for the operation of the company only by the shares and their value, and not by their entire property. Once more, there is a share in the focus, the capital, and its owner remains secondary.

Deprived of personality in its creation, the capital represented in shares only subsequently becomes tied by ownership to a person, legal or natural. Equity companies which are not joint stock companies cannot be formed without prior designation of an owner. Neither can they be traded without prior identification of the owner – partners in a limited liability company. And, for example, they need to agree beforehand on a sale of an ownership share. Open joint stock companies know of no such determinants.

II.2.8. Trading shares

By making the market less and less shallow, by gaining such traits, shares attract traders again, who have one-time interest. However, they do not want anymore to dissolve the company as their interest ceases to exist. On the contrary, preservation of activity of the joint stock company represents *conditio sine qua non* for making their one-off profit. Share turnover in simple trading transactions is facilitated by their elementary characteristic – they are depersonalized ideal shares of a capital. As such, they are easily measurable and easily transferable, they are tradable.

All holders of shares in one moment should not be confused with shareholders and shareholding as described above. Those who buy and sell shares for a one-off profit should not be regarded to be other than what they really are: traders. Traders are interested in profiting on price fluctuations in stock exchange speculations. Their interest is a trading interest, and for them shares are types of commodity – a tradable object. However, they too are interested in the company's activity and its continuance, since it directly influences the price of the commodity they are trading - shares.

And in this manner as well, a share as a symbol of value becomes detached from the issuing value of the share. Market stock prices depend on demand and supply, and their resultant value need not necessarily match the value of the company's capital. This became even more noticeable with printing of issued shares.

II.2.9. Printed shares

A printed share becomes in the real sense, a value symbol, and a reflection of the company's ideal capital. Nevertheless, the share on paper continues its life on the market without being linked in absolute terms to the performance of its issuing company. A decisive factor on the market is the opinion of investors, their expectations from the company, and therefore anticipation of movements of stock prices. Issuers of shares are aware of this too, and they strive to make the anticipation as favorable to them as possible.

As a symbol of value, shares were supposed to conjure up the highest possible value by the way they looked and thus attract new shareowners. From the moment they assumed the form of a lasting security, replacing time-defined contracts in various forms, they increasingly resembled artistic lithography. First-rate artists and printers/lithographers were engaged for their making.

The appearance of a printed share, therefore, should first convey value; it should indicate that this is a security. If not the value per se that remains linked to the share's issuer – the joint stock company – then its own value, which has an independent life on the capital market. For this reason shares emulate bills. There are many elements that can be identified on the certificates which are the same as on paper money, only placed over a larger surface.

To begin with, each share certificate is adorned by a border. Most often it is created by application of complex geometric figures, exquisitely interwoven. Then, many certificates portray an allegory of the state, i.e. the country of the joint stock company. The allegory is often accompanied by other figures that directly indicate location of the company's headquarters.

Serbian stock certificates frequently portray a young woman, representing Serbia, and also often have ornaments copied from rugs woven in Pirot, or girls or young men wearing folk costumes of different parts of the country. The stock certificate of the Serbian-American Bank, one of the prettiest certificates printed in our country, in Art Deco style portrays a silhouette of the Statue of Liberty located in New York Harbor and a silhouette of the city of Belgrade with Saborna crkva (*Cathedral Church of St. Michael the Archangel*) prominently displayed.

Allegorical figures are added in the vignette to represent activities of the joint stock company, but also to glorify coveted qualities of an entrepreneur. Thus Hermes, god of commerce accompanies the goddess of vegetation, if it is an agricultural company or cogwheels for industrial ones. In addition to the aforementioned, a bee and its beehive are a common motif symbolizing diligence and assiduity.

In the end, state administrations became directly involved in shareholding and regulations on how a share certificate should look. Thus, each share certificate needed to have an embossed stamp, along with the other counterfeit protection measures. Then, share certificates were required to contain excerpts from the company's rules. Naturally, face value was compulsory too, denominated in the national currency, rarely in a foreign currency. It is worth mentioning that the share's importance lies primarily in determining a part of equity that each one denotes. The true (market) value of shares is determined on the market, above or below its original face value.

Dividend warrants and an allonge affixed to the share as its constituent part were printed also. This gave a final look and form to share certificates: on the front of a large sheet of folded paper was the face of the certificate containing a serial and a control number with all counterfeit protections; the folded part of the sheet were actually the dividend warrants, each with identification numbers of the share certificate.

A warrant was printed on the back for each year. Upon payment of dividends for the year, the warrant would be cut off. When all the coupons were cut off the back of the share certificate, a shareholder would be left with a cut allonge serving as a basis for a new warrant sheet, which again would be attached to the certificate.

Large and important joint stock companies were trying hard to make their share certificates look as pretty as possible. This was a matter of prestige, a form of marketing among the investors. It was assumed, that the more valuable a share certificate looked, the more investors it would attract. It is paradoxical, but it was necessary to attract more investors in times of crisis, and it occurred that the finest certificates were printed then. The best example for this is Russia, in the time of the provisional government of Kerensky to the October Revolution. The certificates that were printed then had much greater value as pieces of art, lithographs issued in limited prints, than their value had ever been on the stock market.

II.2.10. Electronic records of shares

From the beginning of the 1980s, the beauty of printed share certificates has been replaced by cold and impersonal, but by all means more functional, electronic shares. In most parts of the world, including Serbia as well, shares exist only electronically – as balance on deposit accounts. Of all the items that constituted them, only the identification marks remained. There are no differences any longer within a series of shares of the same issuer. Shares are homogenized, in a way that each share individually provides its owner identical entitlements as any other share.[132] This made shares even more marketable, made them a step closer to characteristics of a commodity as a trading item, i.e. genera. Security identification signs include CIF codes and ISIN numbers. The

[132] Naturally, these are common shares. Preferred shares carry superior rights to their owners, but they are designated by different codes.

way these identifiers are determined was regulated at the world level using a unique technology, which made each share regardless of its place of issuance, closer to the global capital market. The CFI code (Classification of Financial Instruments) is assigned on the basis of the security type classification, while ISIN (International Securities Identification Number) uniquely identifies a security. These security identifiers contain information about the issuer of a security and whether it is, for example, a preferred or a common share.

II.2.11. Significance of shareholding

The significance of shareholding is manifold. The economic importance is the one most spoken of and the most obvious. Without permanent pooling of capital in commercial and industrial companies, many markets would have remained unused, many projects failed and the economy condemned to languish within local boundaries. The global economy was first created in business activities of large joint stock companies and on the capital market, as a setting indispensable for its operation. Likewise, the national level is a setting where shareholding makes use of 'dead' capital for the purpose of economic development, much more efficiently than the savings.

The importance of shareholding in the political and social sense is not of lesser significance, though it may appear so, being less apparent. Pooling a large number of small anonymous pieces of capital made it possible for small owners to have a rent to live on, not to rely solely on remunerations received for the work done. This made shareholding a pillar for development of the middle class, the one that today sustains the regulated advanced democratic societies. There can be no advancement of civilization without a developed middle class. The middle class emanates from small properties and the profits reaped thereof. Shareholding is ideal for rapid development of such property and therefore the middle class itself.

For its own survival and expansion, the middle class adopts a system of value based on protection of private property, one of the three pillars of every civilized society (along with protection of life and liberty). Stemming from this underlying value, the system supports cultivation of diligence, hard work, punctuality, and respect and inviolability of other people's property.

Therefore, the middle class creates a system civil societies rest on. Its destruction destroys the very structure of the society. And the fastest way to wreak destruction on the citizenry is to attack its property. Hence all the dictatorships encroached upon this first, from the Russian occupational government in East Germany, which immediately started collecting and destroying securities, to the Belgrade liberation forces that burnt down the archives of the Belgrade Stock Exchange in the winter of 1944/5. And vice versa, the end of a dictatorship is followed by strengthening of the middle class and citizens' consciousness – from Chile under Pinochet to Serbia in October 2000.

The social class seeks its place in the political system. In the way it prevails in it, it adapts the institutions to itself. Finally, shareholding as an economic democracy – rests on the same principles as political democracy – from the confidentiality at the level of participants to transparency at the level of institutions to being replaceable.

Some of the principles found a deeper and more perfect application in shareholding, such as division of responsibility and risk, where every person is empowered to decide on his/her own to what extent responsibility and risk are to be shared by purchasing a specific number of shares. Similarly, the massive shareholding will not yield results if it is not qualified i.e., if the person investing is not aware of the consequences thereof – and the easiest to become aware is to learn through the potential investment, resulting in a synergetic effect by institutionalization through purchase of shares.

Although the principles of economic and political democracy remain the same, their application differs in some essential points. While, votes in a joint stock company are cast on the basis of the shares owned, this, however, is not possible in a political system.

STOCK EXCHANGE

II.3.1.The most developed part of the market

Shareholding was one of the assumptions for the development of capital market institutions. Once legally set up, the formalized and standardized capital became convenient for efficient trade. The turnover of capital, i.e. its participation in the market, branches off largely, though not fully, the primary relation from which it was created.

The turnover of capital in the form of securities drove the creation of a special segment of the market – the capital market– with the stock exchange as its main institution. The stock exchange was created to meet the needs of the capital market, and it is linked to this market to such an extent that it is most often wholly identified with it.

The words 'stock exchange' relate in the narrow sense to the institution itself. However, the words 'stock exchange' also encompass a physical place i.e. the building where it is located. In some languages, it also refers to the set of operations being conducted on the stock exchange, particularly in the context of the tendency of price movements.[133]

According to Weber's market classification, the stock exchange surely belongs to regulated, organized markets. Stock exchanges are formed spontaneously when merchants – intermediaries – join and accept operating rules in order to maximize profit. This is how the stock exchange regulation should be understood – the stock exchange as a regulated market, where regulation occurs by accustoming to the traditionally accepted conditions of trade.[134] It is not about the limitation

[133] e.g. 'the stock exchange has strengthened in today's trading'

[134] Max Weber, *Economy and Society*, Serbian edition Prosveta, Belgrade,

of market freedom, but about its regulation. After all, a stock exchange cannot arise in an environment other than the one making up a free market.

Weber emphasized both the legal and ethical dimension of the stock exchange.[135] The latter was underscored not only by theorists, but also by merchants themselves – i.e. intermediaries on the stock exchange – once they became aware of the importance of the institution that they had built.[136] Weber also underlined the political role of the stock exchange, acknowledging its major significance in economic international struggle.[137] These standpoints can be found also with stock exchange intermediaries.[138]

According to many theorists such as Alfred Marshall,[139] the stock exchange is the most perfect segment of the market. This assertion was reiterated by the most influential professor of the Faculty of Economics of Belgrade University between the two world wars – Velimir Bajkić. Simply and clearly, he considers the stock exchange the most perfect market.[140]

1976, p. 57.

[135] 'Weber emphasizes the legal and ethical dimension of operation on a modern stock exchange…', Richard Swedberg, *Principles of Economic Sociology*, Princeton University Press, 2003, cited according to the Croatian translation: *Načela ekonomske sociologije*, Mate Zagreb and CID Podgorica, 2008, p. 119.

[136] 'The stock exchange also has a great educational and moral power. It affects the raising of awareness, deference and trading skill, instructing everyone, without a difference, to work with more attention and to finish their jobs quickly, affordably and reliably', Belgrade Stock Exchange Yearbook, 1904.

[137] '... however, he was also fascinated by the political role of the stock exchange – its role as a 'means of power' in the economic struggle among nations', *Principles of Economic Sociology*, Croatian translation, p. 119. For more information on Weber's opinions of the stock exchange see his article *Die Börse*, published in 1894.

[138] 'Finally, a stock exchange is a major political factor; its importance comes to the fore as economic interests of a nation are more engaged in the international match', Belgrade Stock Exchange Yearbook, 1904.

[139] 'The stock exchange is the example of an organized market. As the matter of fact, like many other economists from that period, Marshall saw the stock exchange as the most developed form of the market', *Principles of Economic Sociology*, Croatian translation, p. 110-111.

[140] 'The stock exchange is the most perfect market', Velimir Bajkić, article *Our Stock Exchange*, magazine 'Narodno blagostanje' of 25 May 1929, cited according: *Izabrani spisi*, Official Gazette, Belgrade, 2009, p. 146.

As such, he attaches to it a great importance for the overall economy,[141] calling it in one of his articles 'the scientific market' as it replaces speculation with knowledge and facts, which enables it to regulate prices.[142]

The development of stock exchanges and trading is the matter of development of the market itself. The stock exchange was created from the market, from its needs – spontaneously. This is how its development continued in parallel with the market and the economy. Therefore, the appearance, widening and development of stock exchanges and operations on them coincide with the widening and seizing of new markets, both in terms of space and technology.

Precisely because of that, the sudden expansion of markets in the New Century caused the development of stock exchanges and their spread in cities of the West. This additionally underscores the main feature of their appearance – spontaneity.[143]

Just like the market, the stock exchange as an institution does not follow dictates outside of the economic sphere. All that goes on the stock exchange and concerns the stock exchange must be based on the needs of

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[141] '... the main impetus of economic development and progress, it is the source of wealth'… '(the stock exchange) is the appearance of initiative in the economic life, a milepost for successful economic work; on top of that, it takes care of the constant, even and favourable satisfaction of individuals' needs, enabling and facilitating exchange.', ibid.

[142] 'The stock exchange is a scientific market; it presupposes a deep study of economic life; it replaces speculation and incidence by knowledge and facts. As such, it meets the conditions to conduct its most important function – to regulate prices', ibid.

[143] The transition of ex-socialist countries modified this principle. It was necessary to establish functional markets in a short period of time, concurrently with democratization of society. For both processes – directly in market terms and indirectly in political terms, the stock exchange is one of the key institutions. It was therefore not possible to wait for the market itself, i.e. market actors, to develop their operations and specialize themselves to such an extent that an institution such as the stock exchange becomes indispensable. Those who relied on such reasoning managed to nullify the positive effects of privatization and not to allow the development of the capital market, which left deep marks on the further course of transition. The examples of the Czech Republic, Slovakia and to a large extent Serbia... serve as a warning. The appearance of the stock exchange institution in the West lasted for centuries. The spontaneity of this process was successfully emulated by Poland in its transition – for example by creating the conditions for capital market development, with the concurrent legal formation of its institutions.

the market and trading. Trading gives rise to this institution, at a certain level.

To facilitate their operations, merchants – intermediaries – created the stock exchange; in time, they specialized only in trading and intermediation in securities. Within their activities, narrower fields of competence branched out as well. Today, stock exchange intermediation is a developed activity encompassing numerous sub-activities. The focal point of all activities remains the stock exchange, in the way it was formed at the beginning as an 'association of intermediaries.'

Other capital market institutions developed from the stock exchange as well; they could be called its extension and include clearing houses and securities depositories. Owing to capital market institutions and their activity, the state developed another agency dealing exclusively with capital market regulation.

II.3.2. Definition

The idea behind the term 'stock exchange' is that it is a trading place. As an institution, it was created based on the need of the capital market and those working on the capital market in pursuit of more efficient trading. It has thus remained linked to its development and the development of the activity of merchants – intermediaries. Even today, despite its manifold social-economic importance, it cannot be separated from its primary purpose. If separated from the market, if it loses its link with intermediaries, it will lose its *raison d'être* and disappear.

The stock exchange is not just any trading place. In order to call a place of trading a stock exchange, two more conditions should be fulfilled. They relate to the subject of trading on the stock exchange and the method of trading applied on the stock exchange.

Trading on the stock exchange takes place without the physical presence of what is traded and without the delivery or transfer of money and the traded item from the buyer's hands into the seller's hands. Therefore, it is necessary that the subject of trading be standardized and described to the minutest detail.

In the process of standardization the trading subject becomes the same by all its features, both in the smallest and largest quantities. Only then, could the trading subject on the stock exchange be traded on a stock exchange. It is only in such circumstances that both the buyer and the seller know what they trade in, at any point.

Depending on their own market environment, some stock exchanges developed trading in products typical for such an environment. They standardized them in the course of processing for stock exchange trading and made them suitable for simple and fast transactions. Some products were thus traded in one or several parent stock exchanges where their global price was set, in the encounter between sellers and buyers from the world market.

Trading without the presence of the subject of trading entails special relations on the stock exchange. They are regulated by a group of rules, put together in special rulebooks. These rules define who can trade on the stock exchange and under what conditions, what could be traded, how supply and demand bids are collected and how transactions are concluded and carried out. The trading rules were developed in parallel and according to the development of trading that they regulated. At the beginning, they were not more than sets of a few principles that regulated the basic relations among merchants. Today, they have become a special branch of commercial law.

The rules, stock exchange tenets, include regulations relating to trading and relations among trading participants, such as the procedure of collecting demand and supply bids, the issue of orders, and matching and concluding transactions. In addition, these rules also prescribe standards relating to the subject of trading. In adopting rules, stock exchanges are largely independent, just like they are independent in overseeing their implementation and sanctioning non-compliance. To this end, special stock exchange courts – arbitrages – operate on stock exchanges.

Combined together, the following three elements define the stock exchange as an institution: the venue, subject and the method of trading, as a place where standardized subjects of trading are exchanged, under the previously set rules.[144] Today, due to advancements in information

[144] Prof. Velimir Bajkić defined the stock exchange practically in the same way, though in different words – 'it is a market where trade is conducted only in exactly determined articles, by a limited number of persons entitled to it, at specific places, at the specific time and under specific conditions, but in the absence of products', cited article, p. 145.

technology, the venue of trading is, in the stock exchange definition, replaced by a virtual one – an information environment where intermediaries trade.

II.3.3. Reasons for existence of stock exchange

Often, the emergence and preservation of the stock exchange as an institution is credited primarily to the efficiency of what we today call stock exchange operations. However, this is only one, superficial reason. The more accurate answer to the question of why the stock exchange appeared and continues to play such a significant role lies deeper. It is tied to the nature of the appearance of what we now consider stock exchange activities and the subjects of trading – the securities and future contracts arising from them.

II 3.3.a Capitalization of expectations

The emergence of stock exchanges is rooted in the seasonal character of particular activities in the economy. The necessity to bridge the gap that occurs from the moment of investing until the moment of realization and the possible profit of some business endeavors gave rise to forward contracts. Once they appeared, contracting parties in sale contracts with the deferred deadline for the delivery of agreed assets could be changed even before their maturity.

These activities, formalized through contracts, produced the first subject of trading that continues on stock exchanges until today: financial derivatives or standardized sale agreements with a deferral clause. The capitalization of expectations was thus the primary reason for the stock exchange appearance and preservation.

The logic of intermediation activity has prompted the search for constant acceleration of turnover. Intermediaries, i.e. those that we recognize today as stock exchange intermediaries – brokers – tried to collect capital from various investors within the shortest possible time, using it to embark on a particular business endeavor.

II.3.3.b Collecting capital

The payment of principal and the appertaining profit would, once these endeavors are completed, always bring them back to the beginning, to the collection of the total supply of the necessary capital. However, the key turning-point takes place when only the appertaining profit is paid out to investors at the end of the endeavor, and the principal remains to fund further activity.[145]

The individual trading endeavor thus became a permanent enterprise, and the document testifying to the level of investment is no longer a forward contract, but testimony to the permanent investment in the enterprise – a share. This provides us with another subject of trading and one more reason for the emergence of stock exchanges – pooling capital. In addition to shares, bonds also testify to the debt assumed, serving as instruments of pooling capital, but without the provision of an equity stake.

II.3.3.c Market liquidity

Finally, the creation of financial derivatives and equity and debt instruments – shares and bonds – thus paved the path to the third reason why the stock exchange appeared and persevered– market liquidity. Constantly striving to increase turnover, intermediaries – now securities traders – gathered spontaneously at frequently-visited places and agreed among themselves to the main trading rules. This puts us back to the increased performance, this time – yet another complex reason for stock exchange appearance.

[145] The chapter on shareholding contains information on the appearance of the first joint-stock company in the present-day meaning of the term – the Dutch Associated East India Company.

II.3.4. Elements of a functional postulate

II.3.4.a Principles

The stock exchange organization takes the form of concentric circles. Such organization has proven the most adequate in setting up, preserving and developing a key purpose of any stock exchange – the reduction in the operation risk. This goal is achieved by institutionalizing several principles that are the constituting elements of its functioning; without one of them, the stock exchange cannot function properly. There are three main principles.

1. Confidence and security
2. Harmonization/correlation with the environment
3. Transparency of trading/public character of operation

Confidence and security

The first of these principles underlying stock exchange operations is the dual principle of confidence and security. As the subject of trading is traded on the stock exchange, it is not physically present; and in case of forward stock exchanges, it is most often not even produced, i.e. it does not exist. Hence, it is indispensable that trust exists among participants in such operations. This trust should not be interpreted as it usually is in everyday speech, as trust among friends or family members. It represents institutional confidence that relies on operating rules, the awareness of penalties for those who break such rules, and on the given warranties.

In case of this principle, confidence concerns the relations among trading participants. Security, on the other hand, regards the relations among the circle of licensed stock exchange intermediaries and their environment. The greatest threat to any market activity was and is the state. On the other hand, due to the importance it enjoys in the system of a market economy and wider, and due to the overall impact on social processes, modern states take the role of additional guarantors of what takes place on stock exchanges.

Such state activities began relatively early. However, after the Great

Depression, states began to secure the stock exchange as an institution, and stock exchange operations, in a planned way. Special capital market regulators were set up, most often called securities commissions. Their role is the provision of additional security of stock exchange operations.

Harmonization with the environment

Like when any other system is instituted, the stock exchange must be harmonized with the environment. The need is even greater, given that the stock exchange arises from the need of such environment, as a response to its problems. Once it appears, such harmonization has a responsive effect and the stock exchange exerts a positive influence on the market that it covers with its activity.

It leads to equalization of price oscillations, contributes to more efficient organization of national economies, reveals the real values of key products for a market and capital of the most important enterprises. In short, it boosts business performances of the market. At the same time, it does that without intervening in the fabric of economy. On the contrary, when it comes to that, it makes use of market instruments.

Trading transparency

Intermediaries gathered around the stock exchange certainly have a special interest in making the widest possible circle of prospective clients informed of what they trade and at what price. The need to adhere to the principle of transparency in their work is somewhat wider than suited to brokers.[146] The best that exists in an economy is traded on the stock exchange, regardless of whether those are key goods or equity capital of the best performing companies.

Everything taking place in a market suffers the immediate effect of stock market developments. Thus, there is a systemic need to know at

[146] According to Velimir Bajkić, '(the stock exchange) is a stage where, in front of the whole world, exchange takes place; it is a glass house containing an exchange-based economy; it is the sun illuminating all corners of the earth where economy takes place; it reveals the secret intentions of entrepreneurs', cited article, p. 146.

every moment, as the smallest measure, three pieces of information: what is traded on the stock exchange, at what price and in what quantities – what, at what price and how much. Stock exchanges provide today much more: the highest and lowest prices in particular time periods, the unmet supply and demand, the payout day and the level of dividends. Therefore, all that can serve in defining business decisions of all participants in the market covered by the stock exchange with its activity.

The stock exchange operation principles are set up through a network of relations among stock exchange members – intermediary companies– and among them stock exchange services/functions, too. The set of all these relations and links makes the stock exchange in the real and functional sense. The aim of establishing and developing the stock exchange, enabling it to function, boils down to the development and widening of the network among stock exchange services and its members – intermediary houses– as well as the encouragement of the creation of the client network of each brokerage company.

II.3.4.b Status and function

The stock exchange is such an institution where the function of the trader-intermediary is separated and ranked above the status of the founder-owner. In the majority of stock exchanges, these two aspects coincide; when this is not the case, the status should be in the background. In a number of stock exchanges, the state became a co-owner, either directly or through special enterprises and agencies. In all these cases, however, the stock exchange has always consisted of the first circle of licensed participants; they represent a condition without which this institution simply does not exist. If certain privileges were to be drawn from ownership and not from the role of the licensed intermediary, this simple purchase and sale mechanism would stop functioning. The only privilege that the stock exchange can accept is the one created on the basis of the trading skill and operational reliability.

Due to their importance for national economies, modern stock exchanges are even supported by their states in this regard. Legislators, directly and indirectly, urge founders to reinvest possibly generated profit by the stock exchange, without dividing it through dividends. The greatest benefit an enterprise can draw from the stock exchange centers on what makes its essence – admission to the first trading circle, either directly or through licensed players and trading within its circle.

If this principle in stock exchange organization is neglected, what invariably takes place is the conflict between the stock exchange owner(s) and its intermediaries. When the conflict lingers, it jeopardizes the stock exchange and leads to its termination, since this principle is one of the main rules underpinning the stock exchange.

The main benefit for a stock exchange member is organization of trading, as best and efficiently as possible. He draws from such organization his own benefit by participating on the stock exchange. Therefore, if he wishes to operate successfully, he must post profit on the stock exchange even before the annual distribution of dividends, based on his possession of stock exchange shares. It is therefore in his interest that the profit is not paid out in the form of dividends, but it should be reinvested in the stock exchange, so that it perfects the trading system to the largest possible extent.

If separated from membership, the owner's function has a completely opposite logic. The owner is interested only in the dividend and nothing more. Reinvestment is taken into account only to the minimum level – as much as it is necessary to keep the stock exchange alive. Of course, this cannot be simply defined because the owner who does not take part on the stock exchange cannot know how it should function and what it needs to function successfully.

This is the source of the permanent conflict arising between the owners and members. The former always think that dividends are low, while the latter have the feeling, justly so, that their business interest is being pushed to the second plane. It is impossible to solve this conflict in a permanent and systemic manner unless the function (of the intermediary) and the status (of the owner) are joined together. According to some legislation, apart from intermediaries, other participants who draw benefit from the stock exchange or are directly related to it may be its owners. For instance, the Vienna Stock Exchange has open-end, joint-stock companies as owners, whose securities are traded on the stock exchange.

II.3.4.c Concentric organization

The pattern of concentric circles is the main feature of stock exchange organization. In this pattern, the greatest rights and therefore the greatest appertaining obligations belong to those from the very heart of the concentric organization – intermediary companies with the highest degree of authorization.

Going farther from the centre of the circle implies a reduction in obligations and therefore consequently in rights, which results in diminished possibility of making profit in the system of stock exchange operations. Developed capital markets have two intermediation levels. There are licensed (clearing) brokers around the stock exchange itself, and they have the right to conclude transactions.

The second circle consists of (introducing) brokers, intermediaries who hold no right to conclude transactions on the stock exchange as they are not its members. They receive supply and demand bids from clients from the wider market and direct them to licensed brokers who conclude transactions for the account of their clients.[147]

Along the margins of this organization there is the widest market – clients of intermediary houses. They represent a passive element in the system of stock exchange operations, but once they enter the system they assume the least obligations. They are required to sell securities or acquire them at a set price.

However, their entry into the system of stock exchange operation introduces additional quality in their everyday work that they would perform even without the stock exchange. This quality limits the operational risk.

The greater the number of participants in the system, and the more complex, diverse and numerous the links established among all participants at all levels, the greater possibilities there are of risk limitations.

Intermediation in such risk limitation is the main activity of intermediary houses gathered into a stock exchange system. In such

[147] They are called clearing brokers and introducing brokers in US regulations.

intermediation, i.e. in connecting those who wish to suppress risk and pay for that an appropriate price and those willing to assume a part of such risk, the intermediary company collects its commission (brokers).

The intermediary alone can directly enter such relations by willingly assuming a part of the risk. Instead of the commission, a share in the part of profit (dealers) is achieved.

II.3.4.d Oversight

The stock exchange is an organization of the whole complexity of relations among intermediaries, intermediaries and clients, and intermediaries and stock exchange services. The organization of relations must be such that it enables the possibility to limit and transfer risk, through strict oversight, on three levels.

1. Oversight of the trading subject
2. Oversight of participants in trading
3. Oversight of relations among participants

Oversight is carried out through stock exchange services, with each of them exercising a special function. The oversight element is sometimes dominant in these functions, and sometimes it is the organizational element, i.e. the organization of trading in such a way that it is (almost) impossible to breach the system rules without causing great damage to the person trying to do that. Stock exchange functions exercised through its services lead us to the institutional organization of the stock exchange, i.e. the stock exchange in the narrow sense, as the very center of the concentric system.

II.3.5. Institutional organization

In the institutional sense, the stock exchange consists of four main services that fulfill its key functions. Accompanying these services are ancillary activities that enable their functioning. Ancillary activities need not be a direct part of the stock exchange, except when the trading function is in question. In regard to this function, the activity of intermediary houses – stock exchange members– represents the ancillary activity, i.e. the center of the stock exchange system with its other elements. There are four key stock exchange functions/services.

1. Listing/membership
2. Trading
3. Clearing and settlement
4. Dissemination of information/disclosure/marketing

These four functions merge into a unique technological whole which commences, continues, develops and ends, forming a circle as described in the above sequence. Each of them may be performed in several ways, but their essence on each stock exchange and on each type of the stock exchange remains the same.

Without establishing one of them, or when one of them stagnates, the stock exchange starts to stagnate and lose its cause in a relatively short period. As practice has shown, this leads to dissipation of membership, plummeting of trading on the stock exchange, and finally to its acquisition by another stock exchange.[148]

As illustrated, in terms of its structure, the stock exchange is similar to concentric circles. In the narrowest sense of the notion, the stock exchange consists of the center itself. The center contains four main stock exchange functions that it took over from the initial circle of associated merchants–intermediaries. These functions are common to all stock exchange members and each of them must have equal access to the functions. They are cumulative. Only when all four of them are set up fully, it is possible to say that the stock exchange has acquired its full shape.

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[148] It rarely happens that a stock exchange, once active, completely crashes and disappears, unless in case of change of the whole environment where it operated.

II.3.5.a Listing/membership

In terms of the technological sequence, listing is the first function. Its task is to ensure that what is traded on the stock exchange is of best quality and that traders in the stock exchange comply with strict conditions.

Therefore, a special service of the stock exchange takes care of business performances of securities issuers, based on which it classifies securities , placing them on one of the official listings or on a separate segment of the market within the stock exchange for securities of those issuers who cannot guarantee the quality of their securities.

Stock exchange members are also subject to control and oversight. Especially prescribed conditions for eligibility to apply for membership should ensure that only verified companies are found in the narrowest trading circle on the stock exchange. The system of membership fees and guarantee deposits additionally ensures the seriousness and integrity of trading participants.

II.3.5.b Trading

The second stock exchange function – the heart of its activity – is trading. To be more precise, as the stock exchange cannot trade on its own, this function represents the organization of trading for members – licensed intermediaries. In this segment of the activity, the stock exchange must ensure the collection of supply and demand bids, the matching of supply and demand, and closing of deals.

This part of stock exchange activities must also be strictly formalized and standardized. Therefore, their significant part relates to the creation of specific stock exchange documents – forms of a special kind – while the other part consists of regulating the dealing with these documents.

The following documents are indispensable for stock exchange trading: the supply and demand order, i.e. the purchase and sale order; the stock exchange supply and demand board; and the confirmation slip as a stock exchange purchase and sale agreement.

In the functional sense, each trade must have two aspects – supply and demand, i.e. sale and purchase. The stock exchange is, above all, a trading institution, and its trading function should therefore have clearly demarcated these two aspects as two starting points of the whole process. The overall stock exchange operation and operation of stock exchange intermediaries is placed among these two points.

The stock exchange must also set up the operating mechanism to offer additional security to participants. This security relates to market volatility that could be triggered by various non-market developments, such as extraordinary situations – from climate (droughts, floods) to political ones (pre-election activities).

In addition to supply and demand, the trading function also includes the intervening individual or a company. The role of this person consists of buying when all others are selling, preventing a sudden and excessive fall in prices. The intervening person also sells when all others are buying so as to preserve prices from excessive growth.

Stock exchanges develop this function with the help of brokerage companies of greater financial strength, which are called Designated Market Makers, formerly known as 'specialists' and market makers, depending on the stock exchange system under which they operate.

II.3.5.c Depository, clearing and settlement

A deal concluded owing to the second function – trading organization – must be settled. For this purpose, it comes under the third stock exchange function: clearing and settlement. This stock exchange function is organized in such a way that it keeps monetary and securities accounts of all trading participants.

The organization itself exited the scope of stock exchanges a long time ago and was entrusted to special institutions that can be owned by the stock exchange or wholly independent, or can be a network of licensed depositories. In case of single institutions, these are most often membership organizations. Depositories operate relying on bank activities as well, due to keeping of monetary accounts. As single institutions, they also operate as comprehensive national securities and as their owners' depositories.

Concluded on the stock exchange, transactions are executed in the depository. Automatically and based on data from the stock exchange confirmation slip, the depository transfers the money from buyers' to sellers' accounts and vice versa, transferring securities from sellers' proprietary accounts to buyers' accounts. Automatic settlement further strengthens the security of stock exchange operations, because a deal once concluded will be executed.

II.3.6. Dissemination of information and marketing

Dissemination of information follows the same pattern as being admitted to a stock exchange and trading in it. The widest circle represents the market as a whole; the stock exchange processes and presents only the basic data for this segment, referring to quantities and the price of particular trading subjects. This is indispensable because prices formed on the stock exchange are benchmark prices for particular subjects of trading, taken into account by all those who deal with securities and goods. The stock exchange organizes this activity through regular daily reports published in the media.

At the next level are intermediaries' clients to whom the stock exchange should disclose all data relating to those subjects of trading to which they are directly related, either as issuers or investors. Finally, the narrowest circle concerns the stock exchange members who should be able to get data on all subjects of trading and their issuers. Stock exchange officers and government authorities in charge of supervision and regulation of this segment of the market could know more of it, but it is important that information destined for the narrower level does not reach someone from the wider level.

Harmonization with environment

Dissemination of information, as one of the four key stock exchange functions is directly related to one of the core principles that the stock exchange relies on – the harmonization with the environment. Every factor of a system exists only if and to the extent it complies with this principle.

In case of the stock exchange, however, this is particularly emphasized. It was created to meet the needs of the environment, and it exists to respond to such needs. It is not only about compliance with the principle in case of the stock exchange, but about its active implementation. Upon its creation, the stock exchange was vested with the recognition of problems in a particular segment of the environment – the market – and the major part of the activity centers on finding solutions.

Transparency in trading

Dissemination of information ensures two-way communication between the stock exchange and the market. It is how the stock exchange is positioned in the market, and the market is offered all advantages of regulated trading. With such a place in stock exchange operation, dissemination of information is indirectly linked to another core principle that the stock exchange relies on – the dual principle of confidence and security. This link is accomplished by ensuring the trading transparency as a foundation of safe trading on the stock exchange.

Dissemination of information is the stock exchange function that permeates its activity from the beginning to the end. It is at the beginning of the stock exchange trading process and every individual activity within it; it continues through the very trading at the heart of stock exchange activity and follows this path until the conclusion of each activity.

Risk hedging

Finally, dissemination of information is the essential prerequisite for legitimacy in stock exchange trading. Without it, any planned activity fails to take place, including trading and risk hedging strategies; it is what makes the stock exchange come to existence and continue to exist. Reaffirmed in this way as well, dissemination of information is one of the key stock exchange functions – without it, the stock exchange cannot survive. It is an instrument of core stock exchange activity, i.e. trading, where to predict means to know, and where predicting means being able (to do something).[149]

[149] 'Savoir pour prevoir et prevoir pour pouvoir' – though formulated to

II.3.6.a Participants

Achieving the stock exchange function is complex. It concerns the structure of the wider stock exchange definition that determines the stock exchange as the center of concentric circles of intermediaries – members and non-members – up to the widest circle – the whole market.

The structure also comprises all participants in this function, who enable its achievement. They are divided according to their roles.

- Active participants
- Passive participants

Active participants

Active participants are those who directly benefit from the products of the information dissemination function in their activity. Furthermore, by their activity, active participants directly contribute to the inflow of information to the stock exchange and further creation of such information.

Active participants thus belong to the stock exchange in the narrow sense of the word and to the first circle around the stock exchange; passive participants belong to the second circle starting from the stock exchange center and to the widest market. Brokerage companies that are stock exchange members, and the stock exchange itself with its services, are such active bearers of the dissemination information function.

Passive participants

Passive participants are those who in their activity have to must use the products of the information dissemination function – once they decide to that that – but indirectly, through active participants. All those entities connected to the stock exchange by their activities, but not trading themselves on its floor, are passive participants. Brokerage

explain another part of reality (environment) than the one inherent to the stock exchange, this principle can obviously be equally used in stock exchange activity as well.

companies that are not stock exchange members and consultancy firms are two of the numerous examples. Along with the passive participants, at the edge of the structure thus defined, are all those who from time to time use the stock exchange trading mechanism in their activities, be they legal or natural persons.

Information stemming from them does not come directly to the stock exchange, nor can it be directly tapped from the stock exchange floor. In the first case, the information conveyors are stock exchange members; and in the second case, they are the means of communication.

II.3.6.b Process

The process in which the information dissemination function is achieved follows the described procedure and participants, the members of the structure. It could be said that the information dissemination function originates with the market, understood in the widest possible sense. The beginning as a determinant should be taken conditionally as information dissemination in the stock exchange operational system is a rounded whole where the information flow is essentially uninterrupted among all participants.

Information flow towards Stock Exchange

We opt for the widest market, as the place of the conditional start, because clients of brokerage companies come from it, and movements in it condition their activities. A brokerage company is a point where market information comes together, as seen by brokers' analytical services, but from the viewpoint of the existing and prospective clients.

In a more developed variant, this information intersection is not essentially linked to a brokerage house. It can also happen, for instance, in a consultancy firm. Then the process continues towards a brokerage house. In any case, the result of such intersection, at the end, transforms into trading orders.

The information process is thus transferred to the second part of the structure, to the second participant, the stock exchange. Here is where the second information intersection takes place, at several levels. The first intersection level is the precondition for operation of the stock exchange and its members as the implementation of the principle of confidence and security relies on it.[150] The place of this intersection is the first stock exchange function, listing. Listing is understood here as the acquisition and verification of information on issuers, i.e. those securing trading objects on the stock exchange and on the stock exchange members.

The next direct flow of the process of achieving the information dissemination function is from the client through the brokerage house. This implies arrival at the stock exchange level where information coming through various trading orders – i.e. various stock exchange members – intersects. This level is linked to the second stock exchange function – trading. At this level, resulting from the intersection of the previous information, we get new information. This is the level, the part of the process, where information is created.

However, it is important to remember that though information appears as an indispensable accompaniment of stock exchange operation, it does not represent the essence of the exchange. Still, information and its movement in the processes described represent the indispensable pre-condition for the existence of stock exchange operation.

This information, created owing to the trading function, may even be called information of the second generation. It moves to the next intersection level, becoming the subject of the third stock exchange function – clearing. Intersection is dual in terms of trading participants and trading subjects.

Simultaneously with intersection at that level, the process continues with the fourth stock exchange function – information dissemination. There is no new information intersection here. Information created in the course of trading, i.e. information taken by clearing, is subject to processing in

[150] In this sense, this part of the process of achieving the information dissemination function could also be designated as its start, which only additionally strengthens the conditionality of determining the start of the process that we opted for.

information dissemination. Processing is such that it corresponds to the stock exchange structure and models it. In this way, products of the information dissemination function are created.

Information flow from the Stock Exchange

The most frequent and popular product of the information dissemination function is the daily report on trading. It is intended for the edge of the structure that we observe – to the widest market. It contains three pieces of information indispensable for creating the basic picture of the direction of market developments: what was traded, in what quantities and at what price. Along with these data, the daily report may contain some other information as well, which may be linked to daily trading but is not necessarily so. For instance, it can detail the level of the unmet supply and demand, the highest and lowest price by different periods, the percentage of price change relative to the previous day, etc.

The daily stock exchange report may contain all the data that do not jeopardize the specific position of stock exchange members and their activities. Products of the information dissemination function, intended for them, contain more information. Along with periodic reports on data created in trading, in the form of weekly and monthly reports, they also receive data at which the listing and clearing functions arrive. These data, through the information dissemination function, are formed in special reports that are available to participants from the first circle of the structure around the stock exchange – the exchange members.

The totality of all data created by information intersection in all stock exchange services is available to the stock exchange only in the clearing function which can, if needed, forward them to other functions – listing and trading. There are no products of the information dissemination function in the form of cross section overviews of what is happening on the trading floor, but only special communications that are prepared *ad hoc*.

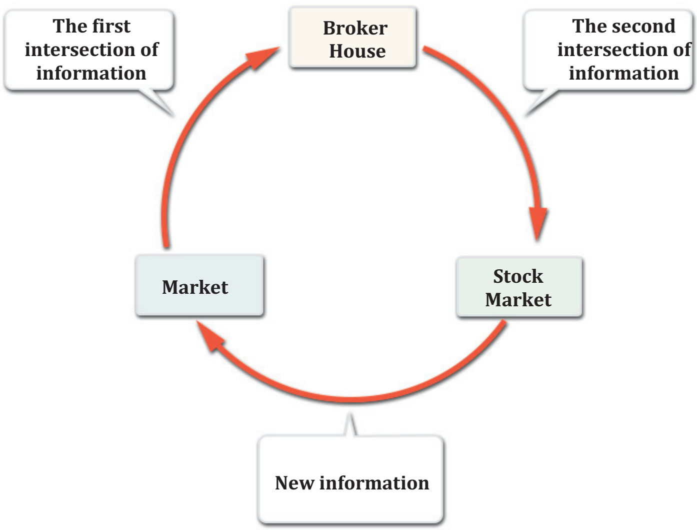
Process finalization

This multi-layer nature and even exclusivity in some points, in the information flow from the stock exchange to the environment, is indispensable for preserving the above mentioned dual principle of confidence and security as the cornerstone of the stock exchange. Its measure and limit that it cannot waive is the maintenance of operational transparency as a means of ensuring trust and security on the stock exchange floor.

Three directions whereby information flows from the stock exchange finalize the process of accomplishing the information dissemination function. In each participant in the described structure, they affect further market behavior. Prices reached in stock exchange trading, which are, for instance, included in the daily report – reaching the widest market through electronic and printed media – affect the perception of market developments with all its participants and thus their business decisions as well.

A part of these business decisions may require materialization on the stock exchange, meaning they will come to brokerage houses. They intersect there with information that they hold and continue their path towards the stock exchange where, once again, they will experience in trading the transfer to the second quality and acquire the final shape in the product of the information dissemination function – the daily stock exchange report.

The whole process of achieving the information dissemination function may be thus shown as a circular route starting and ending with the market, as the graph below illustrates.



II.3.6.c Means

Means and information

The information conveyor is not only a mere technical device, neutral and without influence on what is being transmitted. There is a multi-layered link among the means, the information, the person who produces information and the one for whom it is intended, through which they mutually determine themselves. The information dissemination function arises when the stock exchange trading develops to such an extent that what happens among brokers should be transmitted to the wider public, in a special way. Before that, one can assume, all four key stock exchange functions, including information dissemination, were merged in a unique activity and with the unique participant, the broker, who got together with other brokers on the stock exchange.

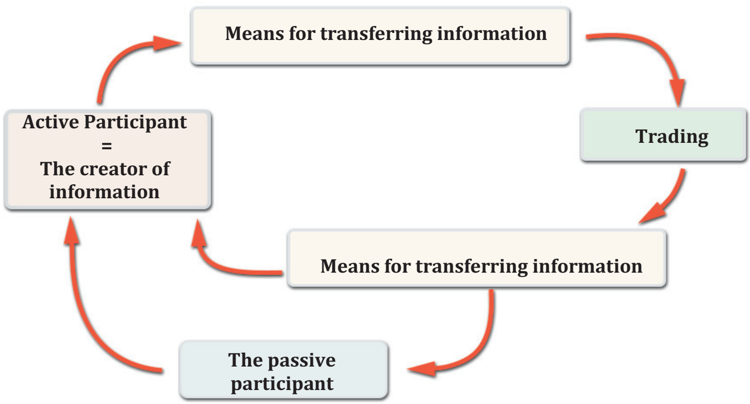
Separation of the information dissemination function implies the use of particular means for information dissemination. Their selection was imposed by the need, inherent to stock exchange operation, to disseminate information as quickly and accurately as possible. This is the origin of the link between the development of the stock exchange activity and the development of the means of communication.

The needs of trading were one of the instigators of perfecting the means of communication. The Phoenician alphabet – the first phonetic alphabet developed by trading people – is an obvious example and a support to this argument, with its improvement in the means of communication having a responsive effect on trading and helping speed its progress.

Means and the stock exchange

Stock exchanges and their activity were already visible when the telegraph and the telephone were invented. The telegraph gave us the ticker – the strip containing information on events unfolding on the stock exchange floor – and developments from it to modern telecommunications serve as instruments to aid active participants in the structure of the information dissemination function to improve their activity.

A similar connection may be traced with passive participants and the data transfer process. The stock exchange report became very early an integral part of the printed media. Newspapers also produce this responsive effect between the stock exchange and the means of information. A newspaper transmits data on stock exchange trading to all interested parties in the market that it covers. The stock exchange, by transferring its data through the newspaper, enhances its positioning in the market and widens its target groups. The links thus created between the stock exchange and the market, with passive and active participants, are portrayed in the following diagram.



In this region, the early example of *Novine Srbske* (*Serbian Newspaper*) is quite illustrative. Guided by the needs of its target group, primarily the trading circle of the Serbian diaspora in the triangle Trieste – Saint Andrea – Timisoara, which regularly published reports from the Vienna Stock Exchange in each new edition. By fulfilling the information dissemination function, we can draw today the conclusion that by the end of the 18th and early 19th century, a few hundred Serbian families (the number of subscribers peaked at almost 500) were either directly or indirectly basing their existence on what was happening on one stock exchange. Here is the example last page from one of the issues dated 1819:

— 612 —

Теченїє новца на ВІЄНСКОЙ БЕРЗИ мѣс. ОКТОВРА год. 1819.

Облигацїе одъ 5. на сто. сребра одъ год. 1816.

	у сребру:		у папїру:
17га. . .	$71\frac{3}{8}$	ф.	——
18га. . .	$71\frac{1}{4}$	ф.	——
20га. . .	——	ф.	——

Облигацїе одъ 1 на сто:

	у сребру:		у папїру:
17га. . .	——	ф.	——
18га. . .	——	ф.	——
20га. . .	——	ф.	——

За 100 Форинтїй сребра.

18га. . . .	$249\frac{1}{4}$	ф.
20га. . . .	——	ф.
21га. . . .	$248\frac{1}{4}$	ф.

БАНКАЛНЕ АКЦІЄ.

Улогъ до 31. Марта 1819 за едну акцїю . . . . . $514\frac{1}{2}$ сребра.
— после 31. Марта 1819 $506\frac{1}{4}$ сребра.

Дисконтъ вексла.

У привилег. австр. нар. банки 5 на сто.

За Аугсбургъ.

	у сребру:		у папїру:	
На 14 дана . .	$99\frac{3}{8}$	ф.	——	ф.
— 2 мѣсеца .	—	ф.	——	ф.

Цѣна раане и усѣва у ВІЄНИ прошаст. субботе, т. е. 18. Окт. 1819.

Ваганъ

	фор.	кр.	фор.	кр.
— жита . .	5	—	7	30
— половнице .	4	36	—	—
— ражи . . .	3	6	4	9
— ечма . . .	2	48	3	36
— зоби . . .	1	45	3	30
— кукуруза .	3	30	5	30

Цѣна масти и свынѣтине ове седмице овд.

	грош.
1 ѿ. масти	10
1 ѿ. свынѣтине . . .	9

ВІЄНА.

Прегледъ цѣне хлѣба и меса за мѣсецъ Ноемвръ 1819. (п. р.)

	ѿ.	л.
Земичке за 1 Кр.	—	$3\frac{1}{4}$
. . за 2 Кр.	—	$6\frac{1}{4}$
. мрке 1 Кр.	—	$4\frac{1}{4}$
. . . 2 Кр.	—	$9\frac{1}{4}$
Пекарски хлѣбч. за 3 Кр. .	—	20
. . . . . . за 6 Кр. .	1	8
. . . . . . за 12 Кр. .	2	16
. . . ражни за 3 Кр. .	—	$28\frac{1}{4}$
. . . . . . за 6 Кр. .	1	$25\frac{1}{4}$

* * *

МЕСО. Говедье. 1 ѿ. 15 Кр.

Securities and Commodity Exchange Report from the Vienna Exchange Market, October 1819. Printed in *Novine Srbske* (Serbian Newspaper), Vienna, October 22, 1819, p. 612.

An even more graphic example at the global level is the appearance and development of the Reuters news agency. It was founded by a German immigrant in England, intending to sell reports on the London stock exchange in Paris and vice versa. It made the first international arbitrage possible, by improving stock exchange operations through the development of the information dissemination function. Reuters illustrates this process to this day, possessing the greatest number of information and information-related services directly linked to stock exchanges.

Computer technology and stock exchange

The application of information technology in stock exchange operations enabled the transfer of information at the moment of its creation. With the increasing role of computer communications in stock exchange operations, there is a heightened risk that the difference between active and passive participants is lost in achieving the information dissemination function.

This fact could be seen to represent progress in stock exchange operations, but only as far as it remains linked exclusively to the information dissemination function. The essence of the stock exchange is not the information flow, but the system of regulated and safe trading. Therefore, if it is possible to eliminate the difference between active and passive participants in the information dissemination function, that is not possible in case of other functions, primarily in case of trading.

II.3.6.d Relativization of some elements of the Stock Exchange definition

The application of computers relativizes some other elements of stock exchange trading. Computer systems and networks enabled trading in a virtual world. We thus need to redefine one of the three elements of the stock exchange definition in the narrow sense that determines the stock exchange through the place, method and subject of trading. The place can no longer be understood as a physical building or trading hall.

The other two elements also had to change from the application of information technologies. However, in terms of the method and subject of trading, it was sufficient to supplement their definitions. In terms of the trading place, however, the change in the notion and its definition is indispensable.

Computerization also reestablished an old quality to stock exchange trading – the lost difference between active and passive participants in the structure that we observe. In case of active participants the barrier disappears that separated the information used for trading (taking its form in the trading order) from the information coming from trading (taking its form in the daily report published in media).

The two groups of information continue to exist independently, but the means of their transmission have become the same. The order is sent through the same computer through which the trading report is received. Both are visible on the screen of the same computer. This is how we arrive at the unity from the beginning, even the creation of the stock exchange – the unity of the person who trades, who transmits information, who receives new information and who reports on it. Now, instead of 'he/she' – the person – we need to say 'something' in the sense of means. In both cases, today and in the past, this is information in real time, i.e. at the moment of its creation, on the spot. Although this spot is no longer a field under plane-trees or the Stock Exchange Home at Kraljev trg 13, but a particular computer network.

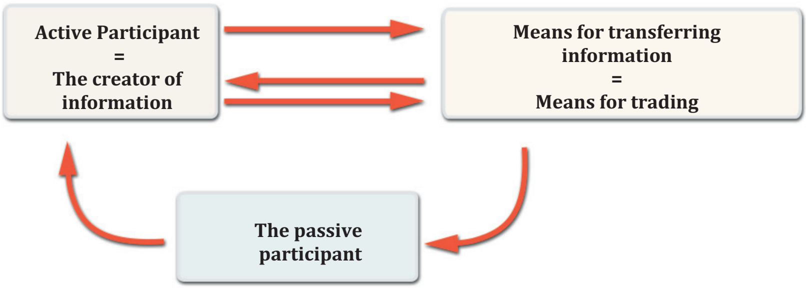
II.3.6.e Electronic trading and dissemination of information

There is no stock exchange today without a computer system as a support to the main functions – not among the newly founded Central and Eastern European exchanges, the relatively new ones of the Middle East, nor the developed Western stock exchanges,. Computers on a stock exchange are not a new feature. What is new, however, and what has become dominant, is the electronic stock exchange.

The initial system of IT support to trading developed into the electronic trading system. This electronic trading system is more correctly called the system of stock exchange operation, because such system covers all four stock exchange functions: listing, trading, clearing, and information dissemination.

In the case of information flow towards the stock exchange, these systems enable system access only to stock exchange members, who are the most numerous subgroup of the active participants group. This flow continues directly to the trading function, wherefrom it moves further to clearing and information. For this part of the information dissemination process, stock exchanges develop their own systems, although the use of special-type, already finished systems is widespread.

Information flow from the stock exchange implies branching in three directions, as we have already explained. Two directions go to subgroups of the active participants group, towards brokerage houses and authorities supervising the operation of the regulated market; and one direction go towards passive participants, i.e. the market as a whole. The systems used for information flow to the stock exchange are also used for the flow from the stock exchange, in case of active participants. They continue to address passive stock exchange participants through the media. The model below illustrates the newly-established relations between the stock exchange and active and passive market participants.



The Internet

The internet has also become a means of communication of the stock exchange with active participants. Today, there are stock exchanges where it is possible to use the internet to send the flow of particular information towards the stock exchange, though it remains an infrequent phenomenon. Much more frequent is the use of the internet and other computer communication technologies for information leaving the stock exchange towards both groups of participants.

The website of a stock exchange can thus contain general trading information and statistical reviews intended for the general public. Along with them, stock exchange websites have restricted segments as well, containing data intended only for active participants. This also shows that the stock exchange consists of particular trading organization for the sake of greater security, whose content cannot (and should not) be changed by the IT revolution.

II.3.6.f Marketing

Marketing is at the very end of the technological chain of stock exchange operations. This function has only been recently developed. First, it appeared as a means to disseminate information about stock exchange developments. As a public and transparent market, the stock exchange had to enable all data important for a particular trading object to reach the widest possible circle of interested and potentially-interested persons.

The marketing function, in the real sense of the word, has become topical for the stock exchange over the past two decades when stock exchanges were re-established in the region of Central and Eastern Europe. This process did not follow the then development pattern – spontaneously, from the market itself, an upward direction. It followed a planned route, and a downward one at that. Due to features of the stock exchange institution and the stock exchange trading methods, care was to be taken of needs and specifics of particular markets so as to harmonize the stock exchange with them.

This gave rise to the need to market the stock exchange, advertising it in order to obtain and ensure the best possible position in the market. This is why it is particularly important to monitor market movements, to collect and analyze market data. Owing to such data, the stock exchange can project its role in the market in the best way. That is why some developed stock exchanges also undertook this activity, aiming to improve their marketing continuously and accommodate it to the needs of their members created based on market trends.

All four stock exchange functions help to accomplish the three main principles on which stock exchange trading relies. If information dissemination is not evenly developed – if it is asymmetric, for instance – the confidence of trading participants is undermined. As regards security, one cannot be confident about making an informed decision in a situation when not all information is there. Further, in an inadequately-developed trading system, the processes depending on it – establishing the real price of capital – cannot exert a responsive effect on the market; the link is lost between the environment and the stock exchange, and the positive influence of the stock exchange along with it.

Both the stock exchange principles and stock exchange functions should be understood cumulatively. Disruption of either the principles or the functions would bring disruption on all the rest, depriving the stock exchange of its essence and of its purpose.

CAPITAL MARKET REGULATOR

II.4.1.The role of a regulator

Financial developments keep an economy alive and vital. Their network makes a functional whole of an economy and links all its segments. Their disturbance inevitably leads to disturbances in all economic areas. That is why special attention is devoted to their regulation in every national economy.

Regulation of developments in the capital market goes through their bearers and through institutions where they converge. Bearers of turnover are broker-dealer companies, banks (general, commercial and specialized) and institutions which emerged for the purpose of their simpler and more efficient progress – stock exchanges and central securities depositories.

In most of the countries, regulation is enforced by an independent governmental authority often known under the name of a securities commission, commission for stock exchange operations (in France until recently), or securities and exchange commission (in the United States of America). In a number of countries, especially those which have undergone the period of organization of their economies, fit for a corporate state, a special division within the ministry of finance, or an agency the ministry supervises, serves as the regulator.

However, experience has demonstrated that the optimum way of regulating the capital market is the one that rests on an independent institution – the Commission. Such an institution is separate from the executive arm of government; therefore, there is no peril of direct political meddling in market developments. The objective of regulation is not to influence developments of capital and money, but to ensure their efficient circulation under equitable conditions for all participants.

By no means, should other institutions, except for the authorized market participants, be allowed to interfere in capital developments. Thus, the Commission safeguards the capital market, protecting it from unconscionable and illicit actions of bearers of the capital developments: stock exchanges, central securities depository, intermediaries. It also, protects them, in performance of their functions, from the involvement and interference of elements outside of the capital market.

II.4.2. Shareholding and the regulator

Shareholding is derived from private ownership; rights of shareholders rest on ownership and almost nothing should limit the will of those holding it. A joint stock company belongs to shareholders and only they are entitled to decide in which way they would admit new shareholders, and in what way their capital contribution will be calculated when entering a company.

Why is it then necessary to deal, in a special way, with the regulation of public joint stock companies? Isn't this a violation of interest and rights stemming from private property and expressed in shares?

At this level, there are some special, peculiar aspects. The regulation of public joint stock companies is necessary, especially because the companies are public and because they are anonymous too. The public character exists because there are many persons involved in their operation, both natural and legal persons, and it would be difficult for any of the owners to manage the operations of such a company on their own or without respecting the will of the other owners.

Shares of such companies are traded on a public market, which adds to the public quality in their operations. By bringing together such a large number of owners, a mass of capital is being attracted and concentrated; and in this way their own capital is increased to the extent that everything concerning the capital is of importance to the society in which the company does its business.

Likewise, anonymity and the featurelessness, impersonal character in the structure of ownership comes from the large number of owners. No one shareholder or small group of shareholders can have an inordinate influence on the management of a company.

In order to gratify the interest of some shareholders, in a most efficient manner, their activities must be deliberated in relation to others.

Only such negotiation can create a majority group of shareholders.

Arguments are necessary for such a joint activity, and those arguments lead to the denominator based on which the largest number of interested shareholders could be gathered. This is easily done by reducing to interests of capital itself to that which would be the most profitable for the company, as the largest number of shareholders would benefit the most from this kind of operation. Thus the interest of capital 'covers" individual personal interests.

Anonymity in public joint stock companies means that the individual human interest is reduced to a minimum and subsumed under the interest of capital. This is what makes shares of such a company, circulating in a market, profitable and attractive to potential new shareholders. By protecting private ownership of shareholders the regulator takes care of efficiency of companies and, thus, of the interest of capital.

Regulation is needed because anonymous individual interest cannot defend itself on its own from usurpation. The interest of capital can be endangered in public anonymous companies by activities of the management, as the management is the one that takes business decisions on a daily basis.

The management does not perceive the company capital as its own, and seeks to transform it from the status of anonymity into personal capital. In other words, the personal interest is closer to them, than the interest of capital.

The current crisis has clearly validated this, among many other oversights (omissions) in the organization of the market regulation and participants therein. That is why IOSCO[151] insists that areas of competence of national regulators of capital markets should be widened to include oversight of issuers, the clearly defined area of supervision of public joint stock companies.

The European supra-national regulatory authority ESMA[152] concurs with this.

The subject of these proposals for supplements to the regulation is primarily the oversight of issues of financial derivatives, derivative securities, all easily manipulated by managements of joint stock companies.

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[151] International Organization of Securities Commissions, see further on in the text

[152] European Securities and Markets Authority

II.4.3. Development of regulations

It is believed that regulation of relations between market participants began very early, back in the Ancient World, to branch and evolve as activities on the market branched and evolved. In the early stages of development, these relations were subjected to self-regulation by merchants. Comprehending the significance of trade for a social community, states strove to put this activity and its bearers into a special, protected position. The protection of merchants, adherence to contracts, and buying and selling contracts, can be traced back to the earliest written records such as the Code of Hammurabi. In the ancient world, the crowning feature of the institutional and legal protection and in other state and legal affairs was the Roman Law. Many legal postulates were established in the Roman Law, now considered topical for the intermediary business.

The Middle Ages left the regulation of commerce and relations between merchants to merchants. Meanwhile, the protection of merchants and their activities remained in the hands of those who had the power monopoly, the state and those representing state. These state actors were most often feudal rulers, from village headmen to emperors, but included the management of free towns, as well. Relatively early, codes of rules and norms were assembled, regulating this area, such as the aforementioned rules governing relations among merchants called the *Lex Mercatoria*.

In mid-14th-century Serbia, the Dušan's Code envisaged strong sanctions for those who violated merchants or trading in any way. Concurrently, it made a leap forward towards regulating the market itself, by establishing market places, places were merchants gathered on certain dates.[153]

Expansion of markets by expansion of commercial roads to distant countries compounded trading and required larger mobilization of money resources. This requires additional guarantees, so the state additionally commits itself to protection and organization of trading. The

[153] Please note the etymology of words: merchants, market from the Latin *mercator* is merchant, trader (also reflected in Serbian, words: *trg, trgovac, trgovina*... *Trg*: initially any place where merchants would gather, not necessarily connected to town squares.)

Serbian Despotate, with the town of Belgrade of Despot Stefan Lazarević, was not falling behind other towns and countries of the developed Renaissance.

In the course of his reign, while the Sava quayside of the town of Belgrade was reserved for battleships, the Danube quayside served for trading. Only authorized traders were allowed to engage in such activities, entitled to trade by a document issued from the office of the Despot. This document was valid as a travelling document at the same time, and was recognized throughout Europe. During the reign of Despot Branković, this activity of the state continued, only the main market place of the Despotate was moved to Smederevo.[154] Of course, the process of developing regulations, especially from the inception of free towns, was not simple and straightforward, without getting off the right path, without conflicts. Trade understands freedom of movement and safety of property, which are two of three bearing pillars of any democratic society, and they often are denied by power wielders. From the Middle Ages to the present day, the regulators of trade have threatened to favor the state and its representatives, to snatch for them more rights, and suspend the rights of others.

The right measure of regulation was and still is determined in a political combat of representatives of merchants – those who would be classified as the middle class today – and those imposing authority and power. Just as this combat was fought in the uprising of citizens in 17th century Bruges against their sovereigns, the Lords of Lorraine; today merchants fight for decentralization of the government administration and revenues.[155] In the 17th century, small owners of minority stakes in companies – shareholders – became involved in this political battle of supremacy.

Of course, market regulation is not merely another term for the political elite obtaining supremacy over national economy. The process of several centuries of determining its right measure has led us to today's perception that regulation of capital should be such as to ensure

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[154] It is more correct to say that Smederevo as a town was erected on the place of an earlier market place (*trg*).

[155] Decentralized tax system leaves a portion of tax revenues, as autonomous revenues to local governments - municipalities. Autonomous revenues represent foundations for issues of municipal bonds.

enhancement of private interests, but not to allow suppression of the general interest for the sake of the private. Hence, we have the firmly-ingrained opinion that, for example, all shareholders should enjoy equitable treatment, regardless whether they are individual persons, companies or a state.

The same rights impart the same obligations. Favoring one shareholder, be it a person or a state, puts others in a position of not being able to satisfy their interests in a lawful way. However, interests go towards gratification and their bearers have to think of ways how to satisfy them, which again leads them to avoidance of legal postulates and institutions, if normal gratification is denied to them. The final result is a state of imbalance on the market, manipulations and undermined integrity of the market.[156]

The development of regulation swung back and forward like a pendulum, between extremes, from overly protected representatives of state to overly protected market participants. The strict and overly-developed regulation suited the first, while absence of any regulation suited the latter. The first situation would lead to centralization and monopolized market and therefore, inevitably to its fading away; the other would ensure abrupt market growth in a short time period and later collapses and crashes and dramatic drops in prices.

The right measure of regulation was determined piece by piece, for some segments of the financial market and its instruments, and almost always as a consequence of significant damage following collapses. The collapses were equally caused by representatives of states, such as the bankruptcy of the Mississippi Company in Bourbon France,[157] as well as a myriad of small participants, with limited knowledge and large appetites, such as the South Sea Company bubble, the British joint stock company,[158] or the Tulip Mania in Flanders.[159] Thus, market regulation

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[156] An example closest to us it certainly the revocation of voting rights to the state on the basis of shares the Share Fund keeps in the portfolio. This has made the state (as a shareholder) to defend its interests by use of – ius imperii, if necessary, a postulate that would tear down any market.

[157] More details in the biographical study about the life of John Law: Janet Gleeson, *Millionaire*, 1999

[158] More details in the: Niall Ferguson, *Ascent of Money*, 2008, the volume in Serbian: *Uspon novca finansijska istorija sveta*, Beograd, Плат Ω, str. 142-161, also in: Burton G. Malkiel, *Random Walk down Wall Street*, W.W. Norton &

was an immediate response to problems which market participants created in it.[160]

II.4.4.The first securities commission

The first securities commission is also the most famous and prominent today, in terms of its development of regulations and its positioning on the national and the global market– the United States of America's Securities and Exchange Commission. From its inception, it had established a model of the most efficient regulation of the capital market, which does not hinder the development of relations in the market.

Its formation too is linked to the collapse of the market which marked the beginning of the Great Depression in 1929. Even before October 1929, the US federal government had tried to establish a regulatory authority for the securities market. The political opposition to the effort was strengthened by the large number of small shareholders who had flocked to the securities market in hopes of participating in the rapid and significant economic growth in the US after the First World War.

In the course of the 1920s, at least twenty million Americans started to invest in shares, increasing demand and raising prices on the market. Companies seized the opportunity afforded by this situation, with the value of new issues reaching $50 billion in the period, from the end of the war to the collapse of the market. Investors and businesspeople were generally optimistic and not even warnings from economists could shake their faith that the growth would continue Efforts to introduce regulation prior to the collapse was seen as the attempt of the state to interfere and limit the entrepreneurial spirit of individuals and their race for riches and happiness.

Even after the rude awakening which started in October 1929, it was not easy to refute this conventional wisdom. Therefore, it was not until investigations were conducted by numerous committees, in the aftermath of the stock market crash, that the US Congress enacted the Securities Act of

Company, New York – London, 1999, p. 39-45

[159] More details in: *Random Walk down Wall Street*, p. 36-39

[160] Similarly as the continuation of the institution of a stock exchange was an immediate answer to disintegration of the old system of providing trade by means of mercantile guilds and at the same time sudden expansion of market in the beggining of the New Age

1933 and the Securities Exchange Act of 1934. The essence of these two laws can be reduced to two principles: Companies publicly offering securities for the purpose of their sale on the market must tell the public the truth about their businesses, the securities they are selling and the risks associated with investing in those securities; and people who trade and organize trading in securities – market intermediaries and stock exchanges – must act honorably and honestly in relation to investors, putting investors' interest before their own.

In addition to these two pieces of legislation, the foundations for regulation of the capital market were laid by the acts enacted in 1940 which regulated debt securities and their trading, investment companies and investment advisors. Their replacements were equal in their importance and proportions to the reform introduced by these original acts. The new regulatory framework was passed in 2002 – by adoption of the Sarbanes-Oxley Act. Sarbanes-Oxley set stricter provisions regarding liabilities of issuing companies, those regulating disclosure of financial information about trading of companies whose securities are admitted to trading on a stock exchange and a special detailed regulation of the area of accounting and auditing. The Act also introduced another institution into the system of financial market – the Public Company Accounting Oversight Board.[161]

The new legislation ensued as a response to three crises which shook the contemporary financial market: the great Pacific crisis; the terrorist attack upon the Twin Towers of the World Trade Centre in New York City; and the bankruptcy of several large US companies, in the wake of discovery of the accounting frauds in balance sheets of these companies. These events influenced the decrease in prices of securities in the market and the volume of trading as well. They are of special importance because they have shown that the financial markets have turned global while the regulation remained at the national level. Therefore there exists the need for additional regulation of national markets, such as Sarbanes-Oxley, and for the cooperation of regulatory authorities at the global level.

[161] These are public joint stock companies, the companies whose securities are traded on a stock exchange.

II.4.4.a Architecture of the capital market

The Glass-Steagall Act and the Sarbanes-Oxley Act represent two models of capital market regulation. Given the importance of the capital market and what is going on there, its regulation will be reflected in the functioning of the economy at large. It can affect the composition of society and prompt core shifts in the social order. Therefore, the advantages and disadvantages of both of the models should be examined more carefully, through a short overview of effects of these two acts on the capital market and the political and economic situation; and we should especially bear in mind the current global economic crisis which stems from one of these models.

Can it be that indebtedness brings more order and organization than centralism? Certainly not. However, it can be far more equitable and efficient, and more profitable for entire society, in the long run.

This is the principle which writers of the Glass-Steagall Act bore in mind, the first act which in a modern sense regulated the capital market. In the 1930s, there ensued other accompanying pieces of legislation, which completed the legal framework of acting and trading in securities.

Amid the great economic crisis of the Great Depression, the legislators were afraid the most of the uncontrolled power of (what we call today) hidden centers of financial power. It was believed that the players on the market had caused the crisis by their irresponsible behavior. They most certainly had not, but they had widened it and expanded it to all segments of the economy and society.

Government institutions of political decision-making faced something which they could not influence at all, and which largely undermined the entire setting of their activities. The state fought back by a set of legislation of the financial market, of which the Glass-Steagall Act was the foremost.

The basic intention was not to allow the process of decision-making about the market to be distant from the capital owners. Therefore, it barred any institution concerning the capital market –, any intermediary, lender, clearing agency – to be so large as to neglect its purpose of existence – the gratification of interests of clients and provision of fundamental services for the owners of capital.

Concurrently, a repetition of powerlessness of the state before mighty bankers was not to be allowed anymore. Governmental officials were elected and had to pursue the public interest, for which they are accountable in elections. After all, to whom are bankers accountable? No matter to what extent the political and the economic elite were linked together before, in times of crisis the political elite would pay for mistakes of the economic elite.

These goals were achieved by strict separation of the activity of banking from intermediation and provision of other services on the capital market. Banking remained tied to long-term activities, while the capital market returned to its original *raison d'être*. Two pillars of the financial system were erected: a static one linked to banks imparting stability; and a dynamic one concerning brokers, providing liquidity to the market.

The organization set up in such a way did not allow banks or brokers to overgrow their clients or increase their power to the degree it jeopardized the public interest by lobbying and exerting influence. Moreover, such a model made gradual recovery from the great economic crisis possible, and it helped construct a shield against subsequent crisis.

The legal framework created a capillary network of intermediaries which enabled a large number of owners of small and medium capital to participate in the economic game. This in return allowed owners of small and medium businesses to easily and efficiently obtain new capital for expansion of businesses. The market deepened and encompassed wide strata of the population, expanding the middle class and, therefore, fostering a stable political and social system.

The Glass-Steagall Act was a foundation for the piece of legislation governing the capital market regulator – the Securities and Exchanges Commission – which also protected private ownership in securities and their free circulation. Finally, it became evident that the wide dispersion of ownership of businesses, through the capital market, with additional protection of an independent regulator was as an environment much more resistant to adverse effects of economic crises.

The nineties of the last century brought something which is hard to logically justify, but it can be explained. Continental European law, obsessed with control in order to prevent future adverse consequences instead of enhancing the current favorable trends, created circumstances favorable to the concentration of financial services in one place.

The further one goes into the Continent, the more it becomes evident. From savings and investment, to voting at general meetings of shareholders and collection of dividends, all is done by one institution. Therefore, the client obligations are reduced to placing money in one of these large financial conglomerates, all under the unchecked assumption that experts in such conglomerates are more qualified to make investment decisions than a client.

Under the pressure of these 'omni-banks' – or using this just as an excuse – only in the US did the atmosphere develop for changes in the fundamental regulatory system created by the Glass-Steagall Act and formation of a different legal framework for doing business in the financial market. The Sarbanes-Oxley Act enabled formation of financial supermarkets in this part of the world in the late 1990s.

The financial supermarkets concentrated considerable financial power which was partly used to influence political decisions. One such decision contributed to the ability of quasi-governmental mortgage loan institutions to avoid the oversight of regulatory authorities, which helped fuel a financial bubble from mortgage derivatives.

Another negative consequence of these 'omni-banks', perhaps in the long-run even more damaging than the collapse of stock exchange indices. These institutions make the market distant from small and medium participants, both investors and issuers. The recent financial crisis has made the gap even wider and prevented these small and medium market actors from participating in economic processes to influence adoption of decisions which concern them the most. Thus, at this moment, the economic democracy was suppressed, and this economically disenfranchises the middle class. That is why political democracy still suffers, and there is no political democracy without a strong middle class.

II.4.4.b Composition and activities

The US Securities and Exchange Commission (USSEC) has five Commissioners appointed by the President of the United States, with the advice and the consent of the Senate. The term of office of each of the Commissioners lasts five years, with staggered terms; one Commissioner's term of office ends on 5 June of each year. In order to ensure non-partisanship, no more than three of the Commissioners may belong to the same political party. The President also designates one of the five Commissioners as Chairman of the USSEC. Their activities and responsibilities include the following:

a) To interpret federal securities laws,

b) To amend the existing rules of the Commission,

c) To issue new rules and procedures so that the Commission could face the changed conditions on the market, and

d) To ensure application of the rules and laws.

Sessions of the USSEC are public, except in extraordinary circumstances when publicizing the work of sessions could damage the public interest. Decisions made by the Commissioners are founded on the clerical work of the staff working for the Commission. The clerical staff is organized into five divisions – corporation finance; market regulation; investment management; risk, strategy and financial innovation; and enforcement – and eighteen offices. . The offices of the USSEC have a wide range of responsibilities, including administrative law, accounting, information technology, investor education to economic analysis.

II.4.5. The French model

The reform of market regulation in France was carried out a while after the one in the United States, though it was driven by the same reasons: the extensive practice of global financial developments which increasingly influenced the national market and several major instances of misconduct on the market. On 1 August 2003, a single unified capital market regulator was established in France. The Financial Market Administration (*Autorité des marchés financiers*) was created from the previous three authorities: the Commission for Stock Exchange Operations (*Commission des opérations de bourse*), the Financial Market Council (*Conseil des marchés financiers*) and the Financial Management Discipline Council (*Conseil de discipline de la gestion financière*).

The very names of these three authorities now comprising AMF indicate the areas of activities of the new French regulator. According to the law, AMF is an independent legal person with financial autonomy. Its mission is to ensure:

a) Protection of investments in financial instruments,
b) Availability of information about financial instruments in the market to all investors, and
c) Maintenance of an orderly financial market.

In addition, AMF provides support to the regulation of the financial market at the European and global level. This obligation speaks clearly of one of the reasons for creation of a big national regulator such as AMF.

AMF includes a Board of 16 members, an Enforcement Committee with 12 members and specialized and consultative commissions. The Minister of the Economy, Finance and Industry designates a government commissioner who has a non-voting seat on all AMF bodies. The Chairman of AMF is appointed by the President of the Republic for a non-renewable, five-year term. A Secretary General manages the work of the staff of the French regulator.

The Financial Market Administration is charged with four major tasks: a) regulating the market, b) granting licenses to market participants, c) supervising the market, and d) carrying out enforcement. These areas of competence give AMF direct responsibility for activities on the financial market, for those performing the activities and for information regarding the activities. It also oversees collective investors and organizers of trading – such as stock exchanges and their infrastructure – as well as direct participants in operations on the financial market.

II.4.6. Competencies of a regulator

Regardless of the model of their organization, be it the American or the French, or a third one, securities commissions in their operations must at all times safeguard the integrity of the financial market and investor rights, and maintain and enhance capital market operations. Their areas of competence include:

a) Oversight of corporate governance in joint stock companies, i.e. the set of mutual relations between the shareholders, management, and creditors of a company;

b) Regulation of the capital market and supervision of market participants – intermediaries, banks and stock exchanges – and their activities;

c) Protection of private property in the form of corporate and debt securities through the supervision of central securities depositories.

Securities commissions also might engage in regulation of financial derivatives. Usually, commissions are engaged in regulation of financial derivatives formed on an underlying commodity, while the regulation of the market of financial currency derivatives is entrusted to monetary institutions (such as in the case of Hungary, prior to the consolidation of the regulator). When larger markets are concerned, such as the US market, there is a separate commission dealing with the market of derivatives (the Commodity Trading Futures Commission).

Regulators of capital markets carry out activities from their remit according to the prevailing model of regulation, varying from a country to country. Owing to the new experience brought by the global economic crisis, the models are being changed and supplemented in an effort to find the best possible solutions to help prevent future crises.

There are consolidated regulators in some national jurisdictions. According to this solution, those which have always been supervised by the capital market regulator – such as stock exchanges and clearing agencies, brokers and investment fund management companies – find are regulated by one institution which also oversees , but also insurance companies, leasing companies, private pension funds... An excellent example how successful this model has proven to be is the Croatian

Financial Services Supervisory Agency (in Croatian HANFA – internationally: CFSSA).

In this manner, balanced regulation is enforced across the entire financial market and all its participants. The central monetary institution is left to engage in its original activity – monetary policy. A very strong argument for such a solution is actually directed to central banks and states that the control of commercial banks by the central bank represents a kind of a conflict of interest. At first glance, this argument might seem to be an overstatement; but it is not so, especially when thinking about the fact that the Central Bank of Montenegro or the National Bank of Serbia have each a better business result in 2010 than the entire banking sector of their respective countries.

Yet another dilemma appears concerning the manner of organization of the capital market. Should regulation rest on principles or rules? Rules entail that any activity in the capital market should be set within a law or a by-law and that any departure from such activity stipulated by a regulation should be sanctioned by an envisaged penalty. It is not hard to recognize the leading principles of Continental Law in this approach. The argument for this point of view emphasizes that it brings legal safety, because all the rules are known in advance and they are known in detail.

Regulation based on principles proceeds from the nature of processes and activities in the capital market and its participants. The capital market is alive and quickly changing, especially in the environment of today's technical capabilities. Its participants adapt to it quickly and along the way, trying to satisfy their own interests and the interests of their own clients; and they adapt to it much faster than legislators could follow.[162]

The answer to such nature of the capital market is taken from the heritage of the Anglo-Saxon legal school. Law should establish the basic principles according to which regulators and all other participants in the capital market should act. A regulator issues bylaws, official interpretative releases and opinions, and in this way regulates how these

[162] 'Part of the genius of financial markets is that, when there is a real demand (…) to enhance speculative opportunities, the market will surely provide it.', Burton G. Malkiel, *'Random Walk down Wall Street'*, W.W. Norton & Company, New York – London, 1999, p. 37

principles should be applied in everyday operations on the capital market.

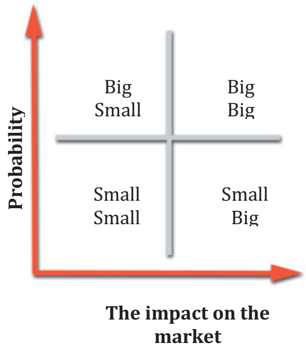
The regulations based on principles are better suited to the spirit of the capital market. However, a statutory solution governing an area must be a constituent of the total legal order. Otherwise, it will not be applicable. The solutions from the Anglo-Saxon legal school should not just be glued to the system of Continental Law.

Some postulates, however, might be equally applied in the regime of regulation based on rules and in the regime of regulation based on principles. At the global level, consolidating solutions are being developed and they are going to be applied in all legal systems. The International Organization of Securities Commissions has been working on this for years.

Today, the introduction of risk-based supervision of market participants has become common for almost all capital market regulatory authorities in the world. The size of the market, number of participants in the market and large number of transactions that may be concluded in short periods of time made it impossible to constantly monitor everything that happens in a capital market and all of its participants. That is why the regulatory authorities have set certain indicators for risky behavior, individually and with joint cooperation efforts through their international institutions. The indicators are continuously reexamined and supplemented, both for the entire market and its parts and its individual participants.

If some of the trends on the capital market are proven susceptible to a risk, regulatory authorities will examine them. Today, these types of actions enable capital market regulators to remain efficient in performing their basic activities. The graph below illustrates simply how the model functions.[163]

[163] As shown by Mr Vaidas Cibas from the National Bank of Lithuania, At the Tornoto Center seminar held in Miločer, April 2012.



Based on the parametres set in advance, the regulator follows whether the market participant's activities fall within one of the quadrants. For example, whether the probability of irregular behavior is high, but with the limited effect on the market. Of course, most of the regulator's activities will be directed to those participants for whom the probability of irregular behaviour and its effect on the market are the highest.

II.4.7. International Organization of Securities Commissions

Globalization of capital markets has created the need for a unique organization of all national markets. The International Organization of Securities Commissions (IOSCO) plays an important role in consolidating the principles of organization and regulation of the capital market. The seat of this organization is located in Madrid.[164]

The International Organization of Securities Commissions (IOSCO) was created in 1983, by transforming an inter-American regional association of regulators which had been created nine years before IOSCO. The national regulators of financial markets in France, Indonesia, South Korea and the United Kingdom were the first to join this newly-set up organization in 1984. Two years after, it was decided to establish the permanent General Secretariat of IOSCO at the regular annual conference held in Paris. Today IOSCO[165] has 115 ordinary members, 11 associated and 66 affiliated members, which cover almost all financial markets in the world by their activities.

There are two key contributions which the International Organization for Securities Commission has made to the development of the capital market regulation. The first is adoption of the Objectives and Principles of the Securities Regulation which were adopted as a document in 1998. The principles became the fundamental standard for regulation of all national markets.

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[164] The source of information about IOSCO: www.iosco.org, in addition to the experience obtained directly in the course of work

[165] Spring of 2011, after the annual conference in Capetown

The second is creation and adoption of the Memorandum of Understanding in 2002, a multilateral document whose purpose is to enable the exchange of information and experience of national commissions and, therefore, facilitate application of general principles. The Methodology was adopted in the following year for the purpose of objective assessment of the level of implementation of the IOSCO Principles. The International Organization of Securities Commissions assists its members in creating concrete solutions for problems they are facing in application of the Principles.

IOSCO has three membership levels: ordinary, associate and affiliate. Only ordinary members have the right to vote, and their representatives are elected for membership in the Executive Committee. Representatives of all members constitute a Presidents Committee, which convenes annually at regular IOSCO conferences. In addition, the work of IOSCO is organized into Regional Standing Committees, the Technical Committee and the Emerging Markets Committee. Members are expected to fulfill four primary requirements.

1) Cooperate in promotion of high standards of regulation in order to ensure an efficient and a fair market.
2) Exchange information in order to assist the development of national markets.
3) Cooperate in establishment of standards and efficient supervision of international transactions.
4) Assist each other in protection of the integrity of markets.

Two events were of special importance for raising awareness concerning the necessity of uniform regulation of the capital market at a global level: the great Pacific crisis of 1997, which started in small stock exchanges along the borders of the Pacific basin and spread quickly to all stock exchanges in the world; and the events triggered by the attack on the World Trade Center in New York, including the revelation during the course of investigations that the capital flows and stock exchanges around the world had been used by terrorist organizations to launder money.

The ongoing global financial crisis has once again shown that it is vital to institute global principles and criteria for the capital market regulations. Even before the onset of the crisis, IOSCO and its members accomplished much in this field. However, after the outbreak of the crisis in the course of 2007/2008, it became clear that the need for more work remained.

Taking this notion as its starting point, IOSCO recommended to the Group of 20 major economies four areas which should become priorities in terms of cooperation and adoption of global, common capital market criteria.[166]

First, IOSCO suggested establishing common financial reporting standards and the accountability of the standard setter. Secondly, building investor confidence, strengthening cross-border enforcement cooperation and addressing concerns about abusive short selling. Third, transparency in markets and disclosure with respect to all financial products. Fourth, establishing global norms for regulators of credit rating agencies, through an IOSCO separate document.

The IOSCO task forces have devised and adopted these principles at subsequent conferences and most of them are applied today.

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To be a member of the IOSCO -has become a clear signal that a national capital market is regulated in a satisfactory way, that investors in that market enjoy protection, and that capital flows are transparent. IOSCO ordinary members are divided into two groups, labeled A and B, depending on the extent to which they have accepted and applied the standards stipulated by the MoU, as well as their adherence to the best international practices. The objective of the organization, proclaimed at the regular annual IOSCO conference in Montreal in 2010, is that all national regulators should meet the conditions stipulated for group A by the year of 2013.

It is of special significance for national capital market regulatory authorities that independence of national regulators becomes a must, insisted upon by international financial institutions, such as the IOSCO, World Bank and the International Monetary Fund.

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[166] IOSCO's open letter to G-20 summit, 12 November 2008, http://www.iosco.org/library/index

II.4.8. Independence of a regulatory authority

In order to be capable of fully meeting the responsibilities and missions tasked before a security commission, it must enjoy triple independence: institutional, personal and financial.

II.4.8.a Institutional independence

Institutional independence is ensured by the fact that a commission is a separately established institution, always in accordance with law, with precisely determined areas of competence. The highest level of institutional independence of a commission is obtained when it is founded and its Commissioners are appointed by the bearer of sovereignty in a state – the national parliament. Thus a part of the sovereignty concerning competencies of the commission is passed from the parliament to the commission.

This also defines the relation of the commission with other institutions in the system such as courts or government. The commission is here equalized, at least formally, to the government and to the central monetary institution – the national bank. In some constitutions, the commission is mentioned as a separate institution, while in other countries its institutional independence is established by systemic laws.

However, in some countries the forming of a commission is left to the area of competence of government. In this manner the commission is reduced to a government agency (until recently in Slovenia – Agencija za trg kapitala). Although in these cases the area of competence of the commission/agency is clearly defined, its independence and institutional capacity is significantly reduced in comparison to the countries in which the parliament elects commissioners. The very fact that the highest officials of the commission are appointed by government and not elected by the country's bearer of sovereignty places them in an entirely different level of relations with other institutions within the system. Direct political dependence in relation to government is hardly avoidable.

The least degree of independence exists in those countries where currently-existing ministries serve as the regulator, most often the Ministry of Finance (such as in Sweden). This does not necessarily mean that such regulation is less efficient. However, over the past ten years, as the capital market has evolved and globalized, more and more countries have emulated the model whereby regulators have the highest degree of institutional independence. Bank-centric capital markets have demonstrated inclination towards such a model, for example, in Germany and the Czech Republic.

A securities commission always is composed of two parts: staff and officials. The staff works on and process matters that come before the commission. Their work includes overview and inspection of documentation concerning certain activities on the capital market (such as takeovers or issues of securities) and proposals of actions pertaining to those activities (such as granting and denying consents). The supervision department, which controls participants on the capital market, belongs to this unit. Organization of securities commissions is conditional on their activities. Thus, all commissions will feature separate departments for legal affairs, capital market participants, issue of securities and activities pertaining to issuance, and oversight of participants in the capital market.

II.4.8.b Personnel Independence

Securities commissions adopt their decisions by voting of commissioners – those comprising the part of the commission made of officials, no matter whether they are elected by the parliament or appointed by government. In the wide sense, the essential independence of commission personnel means that neither the staff nor the officials of a commission should be exposed to pressures of any kind, when preparing decisions of the commission and when deciding on them. In a more narrow sense, independence of personnel is associated with commissioners only.

The process of electing commissioners, whose number varies from country to country (Romania, for example, has seven, whereas Serbia has five), should ensure the autonomy of their future work. Therefore, the higher level of autonomy is presumed if commissioners are elected by the parliament, because then the process is public. To a great extent, independence of personnel is contingent on a commissioner's his personal, professional and moral integrity.

However, one should not delude oneself that it is possible in any society to achieve absolute independence of views, opinions or decisions. Societies as organized units are formed around some interests, in order to gratify them. The interests are legitimate no matter whether they are political, economic or of other kind.

Their suppression does not mean their disappearance, but merely their shifting from the public into non-transparent flows. Institutions of a system are established because interests need to be expressed publicly and so that control could be established over them. Meanwhile, processes and procedures of decision-making in those institutions should ensure a general synergetic interest from such a mass of individual and group interests.

The process of electing commissioners and managers of other independent institutions, such as governors in central monetary institutions, is inevitably political and guided by certain interests.

Therefore it is best if this process is placed in a country's parliament, since the parliament is an institution channeling political partisan interests and which has all the instruments to generate from the partisan interests a general, state interest. The process of appointing commissioners by a government does not entail this kind of publicity and subordinates formation of a significant institution to daily, political, narrow, partisan interests.

Publicity of parliamentary processes also ensures that commissioners are experts, as none of the parties would risk political harm from a public proposal by a layman-commissioner. Considering that commissions do have several commissioners and that decisions in a commission are made by voting, it would be hard to imagine supremacy of a partisan interest in the process of decision-making in a commission. This and the supposed expertise of a commissioner, which is always stipulated by relevant statutory provisions, helps ensure personnel independence in the work of a commission.

Still, there will be always parties who try to influence decisions of a commission in a certain way, be it an association of shareholders or something coming from the sphere of daily politics. Hence, there are different solutions to enhance the independence of commissioners by acknowledging and channeling such interests.

For example, for a long period of time the French Commission for Stock Exchange Operations (*Comission d'operations boursieres*) was comprised of representatives elected in the parliament and of representatives of those involved in the capital market (issuers of securities). This arrangement recognized and balanced the different interests which collided at the capital market and in the area of politics.

Other solutions channel political interests specifically, such as staggered election of commissioners to avoid a situation of all their terms-of-office ending at the same time. In this manner, a majority in a parliament could change only as many commissioners as the number of years in power. At the same time, commissioners cannot be changed all at once, but one per year, as their term-of-office ends, thus ensuring continuity in the work of a commission.

II.4.8.c Financial independence

Financial independence of a securities commission is a crowning feature of its overall independence. Without financial independence, the aforementioned measures are mooted. Commissions must not be tied to a state budget. Their income must be derived form their own revenues from fees and charges for procedural activities of the commission. Part of the collected assets should be invested in development of the capital market, organizing different forms of education and promoting shareholding, for example. In addition to helping insure their independence from financial influence, independence of revenue encourages commissions to work in an efficient manner, without bureaucratization.

In some countries, such as Serbia, a potential surplus of revenues over expenditures is paid into the state budget. However, it is more common to leave securities commissions to manage their own resources by themselves, without imposing any obligation of paying the surplus into the budget (as is the case in Montenegro, for example).

Croatia uses a combined solution, whereby the regulator must pay a part of the surplus of income into the state budget and part of the funds are kept for development of their own activities. The financial plan of a commission is usually adopted in the same way as the financial plan of a central monetary institution, with the parliament approving the plan following discussion in the appropriate parliamentary boards.

The income coming from sanctions paid by those who violate laws or rules of the capital market, most often do not go to the account of a commission, but to charity or directly to the state budget. This avoids the motive of issuing fines to increase the regulator's budget. .

In some instances, where the commission is appointed by the government, there is no mention of financial independence, and the work of the commission is financed by the state budget.

PART THREE

DEMOCRACY RESTRAINED

III.1.1. Political body

Democracy was meant for many, but few deserve it. Democracy entails active involvement in processes organized by its institutions, by those to whom democracy belongs. Active participation does not merely imply periodic voting and a choice among several political options offered; it entails continual determination of one's stance towards social and political processes and constant engagement with activities. It also means sustained efforts to improve one's own standard of living and conditions for survival, by exerting pressure within institutions on decision-makers within government institutions.

Social affairs, *res publica*, are handled in the institutions which make the organizational network of society. As illustrated in the previous chapters, social communities are formed and organized around economic activities, but in such a manner whereby those who manage the communities institutionalize their positions in society. In addition to economic interests, the established institutions become places of resolving the other interests as well, although they remain linked (be it indirectly) to the economic.

There are few aspects of public life of a community which cannot be ultimately reduced to economic interest. What cannot be reduced to the rational economic interest and becomes subject to resolution by public institutions often undermines the stability of the society and leads to its collapse and ruin. Even dictators might contribute to the prosperity of the community in the course of their reorganization of a nation's economy; though when they follow their own view of governance of their and other societies, conflicts are provoked.

Democratic government inherently restraints some of these negative tendencies. A society organized as a democracy, still has a network of institutions led by people who also represent certain social groups and political parties; and they have entered the political stage upon winning a mandate to gratify their own interests and the interests of the social group they represent in determining the political course of their institutions.

The need for decentralization is inherent in democracy. It broadens the institutionalized network, hindering the easy domination of society by a single interest, while at the same time bringing the institutions closer to the direct participants in political life. Such spread of institutions facilitates a synergy of different interests whose attempts at gratification underlie different institutions in society. The result is no gratification of interest in absolute terms, but partial gratification of everyone's interest. This is the greatest achievement of democracy in its course of development to date.

No social system, including democracy, is organized so that everyone can participate and make decisions concerning the public policy of a community. It is indubitable that democracy at least has the principal aspiration to include as many participants as possible in its processes. However, this goal often remains on the level of an ideal theoretical model. Members of a community educated and instructed to take an active approach towards all that happens within a community never quit the process; but few people actually possess a level of social interest which leads to involvement in public affairs in a community.

According to theorists who studied this issue, social interest can be expressed in various ways. John Dewey, for example, says that the system of public education can aid the development of citizens' merits. He argues in his work *The Public and its Problems*[167] that democracy should rely on assuming responsibility by a stable and balanced development of mind and character.[168] Upbringing thus becomes a social function and the social environment an educative factor. For the social environment to be democratic, the upbringing in it has to have a two-fold aim: social and civil effectiveness. Dewey links the former to competence and technical education and the latter to culture. According to Dewey, such a social

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[167] John Dewey, *Public and its Problems*, 1925, New York.

[168] Christopher Lasch, *The Revolt of the Elites and Betrayal of Democracy*, according to the Serbian edition *Pobuna elita i izdaja demokratije*, Svetovi, Novi Sad, 1996, p. 80.

structure develops citizens who show the ability to wisely form judgments about people and actions and to play a decisive role both in the adoption of laws and in obeying them.[169]

Meanwhile, Mancur Olson contends in *The Rise and Decline of Nations* that another way is to have as many people actively involved in public affairs, by means of special incentives. Olson claims that 'the paradox [...] is that large groups, at least if they are composed of rational individuals, will *not* act in their group interest'.[170] Friedrich Hayek likewise had arrived to the same conclusion earlier on. However, he phrased it in a more general way, writing, 'The problem is [...] because in the world as it is men are, in fact, not likely to give their best for long periods unless their own interests are directly involved'.[171]

In Hayek's opinion, it is necessary to have certain incentives so that members of a social group or a community will undertake activities of general significance. Hayek also believes that it is wrong to reduce this problem to whether people are willing or not to make an effort. The problem of being interested in an action should take into account the necessity of incentives to act. Hayek concludes 'The problem of incentives in this sense is a very real one [...]'.[172]

Olson takes the same stand and elaborates on it. He says that it is not sufficient to have established and developed institutions in a society, with developed and prescribed procedures; certain incentives are also vital to have the institutions used. Olson argues that 'selective incentive can be either negative or positive […] a loss or punishment imposed only on those who do *not* help provide the collective good'.[173]

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[169] Dewey John, *Democracy and Education*, according to the Serbian edition *Vaspitanje i demokratija*, Obod, Cetinje, p. 87.

[170] 'The paradox is that large groups, if composed of rational individuals, will not act in their group interest', Mancur Olson, *The Rise and Decline of Nations*, Yale University Press, New Haven and New York, 1982, p. 18.

[171] The problem is that in the worl such as it is, people are not inclided to give their best over a longer periods of time, if such activity does not pursue their own personal interest, F. A. Hayek, *The Road to Serfdom*, University of Chicago Press, p. 138.

[172] 'The problem of incentives in this sense is a very real one...', ibid., p. 138.

[173] 'selective incentives can be either negative or positive… punishing those who fail to bear an allocated share of the costs of the group action or they

It is also possible that the number of active members in a social community is suppressed on purpose. This phenomenon, so typical of democracy as well, is fueled by rent-keeping by those who have already secured positions in social institutions. Wishing to keep the positions and direct the course of public affairs as long as possible, they establish restrictions on participation in public affairs through institutions under their control.

Max Weber, writing about social groups and communities, recognized this inclination of those who monopolize public positions to hinder the participation of potential new members of the communities. If monopolization of acquired positions is overly strong, then the entire community loses its faith in democracy and starts to weaken with time.

Weber claims that such monopolistic tendencies had a considerable impact, *restraining* expansion of communities. For example, ancient Greek democracy strived to limit the number of people enjoying the benefits of citizenship, but limited the expansion of its political power as well.[174]

Democratic social restraint is twofold. It is restrained by the weak interest of members of a social community, and it is restrained by the excessive eagerness of some of the members of the social community to constantly direct the resolution of public affairs. What Weber labeled as monopolistic tendencies can be recognized in his example of slave-holding democracies – ancient and modern – and with political party elites. This tendency which he describes does not represent only a transient phase in the development of social systems, and it is not linked to democratic social systems. It is present in all regulated social communities as a natural expression of aspiration to prolonged security in an insecure and constantly-changing world of human interests.

Social systems, whatever form they take, are not designed so that all interested parties participate in directing the ways and methods of management of public affairs. Even when they establish this in principle and as an ideal, as in the societies we call democratic, there will be no full participation of all potential stakeholders in public affairs. Most of them

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can be positive inducements offered to those who act in its group interest', Olson, ibid., p. 21

[174] Max Weber, *Economy and Society*, according to the Serbian edition *Privreda i društvo*, I–II, Prosveta, Beograd, 1976, p. 281

will not possess any internal drive to join in the processes of resolving public affairs, and some social groups and individuals will not be recognized or accepted by the social system itself as relevant participants.

Therefore, social systems concern a political body in a social community which is active in public affairs, or for which it is presumed that it would be interested and willing to participate in the resolution of such problems. The interest for resolution of public affairs stems from the need to resolve individual or group interests through them, i.e. to create and continue creating over a prolonged period of time a setting favorable to gratification of interest of those involved in political life.

III.1.2. Dictatorship and demagogy

The historical development of democracy would be hence more appropriate to follow, not regarding its relation to other forms of organization of social communities, theocracies or dictatorships for example, but rather through conquering the space among those to whom it was intended for and those putting it to use. In the course of its development, democracy was linked to different idealized conceptions of society, such as utopia or a classless society, a society of full democracy, a society of free associations of united workers, etc. The more it declared its link to freedom, the less it provided freedom in implementation of such thoughts. Even Thomas More asserted in his *Utopia* –, utopia being the most perfect of all societies – that rulers of the Island should occasionally have the people do public works.[175]

Democracy is only one form a social community can take. As with other forms, which were basically classified for the first time (as we know it) by Plato in his *Republic* [176] and then in more detail by Aristotle in *Politics,*[177] it aims to be a system encompassing the entire society. Those studying social and political theory, or at least those trying to apply it to the theoreticians of the more recent age, did overlook at least one of three facts.

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[175] Thomas More, *Utopia*, the edition in Serbian: '*Utopija – o najboljem uređenju države i o novom ostrvu Utopiji*, Kultura, Beograd, 1963, p. 103.

[176] Πλάτων, *Πολιτεία*, V/IV в. п.н.е.

[177] Αριστοτέλης, *Πολιτικά*, the middle of IV century B.C.

- First, that any society is stratified, rather than a unique whole comprised of a mass of identical interests and incentives;
- Second, that a form of leadership might be ideally suited for a stratum of society and be the best for it, while for the other some other form of a social system may be better tailored. The dictatorship of proletariat or the syndical revolution are only some of the new examples of the fact that one stratum of society prefers a specific form of a social system;
- Third, that in the entire society, and in some of its strata, not all participants are interested in gratification of their own interest through participation in public affairs.

The political body of a society is always narrower than the society itself. It can be reduced to a stratum only, by means of Weberian monopolization. It also may formally encompass representatives of several strata, and even of all strata, the representatives of which will then remain disinterested in taking participation therein as demonstrated by Olson. However, it never comprises all potential politically active members of society.

Speaking of methods of organization of social communities, democracy being one of them, Aristotle wrote that what he explained concerned the entire society. However, it concerned only Aristotle's contemporary political body, which at the time meant a narrower stratum of those living in Athens or in one of the other Hellenistic poleis. Therefore, it concerned free male citizens of a polis. Aristotle himself clearly set forth in his *Politics* his approach characterized by exclusivity:

'It is also from natural causes that some beings command and others obey, that each may obtain their mutual safety; for a being who is endowed with a mind capable of reflection and forethought is by nature the superior and governor, whereas he whose excellence is merely corporeal is formect to be a slave.'[178]

Depending on the social system, even such a narrow political body could be even further narrowed. As Aristotle put it:

'[...] so that with them a herile government is one composed of a very few, a domestic of more, a civil and a regal of still more, as if there

[178] Quoted according to: Aristotle, „*Politics – A Treatise on Government*", EBook #6762, June 5, 2009, www.gutenberg.org, p. 14, the Serbian edition: Aristotel, *Politika*, BIGZ, Beograd, 1975, p. 4.

was no difference between a large family and a small city, or that a regal government and a political one are the same, only that in the one a single person is continually at the head of public affairs; in the other, that each member of the state has in his turn a share in the government, and is at one time a magistrate, at another a private person, according to the rules of political science.'[179]

The size of the political body, i.e. the participants involved in public affairs, depended on the form of the social system employed, and that was the case from the time of Aristotle to the present day. Involvement in public affairs, for example, encompassed more participants in the aristocracy of medieval and Renaissance Mediterranean towns than in a monarchy of the time. From the New Age to date, it still encompassed more participants in democracy than in aristocracy. The social base of the decision-making process is therefore the widest with democracy.

Aristotle divides governments into three systems and describes the forms into which they degrade: monarchy into tyranny, aristocracy into oligarchy, and democracy into demagogy. In each case, the political body shrinks, even if it seemed otherwise at first glance. While demagogy is not far from tyranny, considering the effective involvement in public affairs, demagogy could be understood as one of the forms of dictatorship and not as deviation of democracy. Savonarola was more of a dictator than the House of Medici.

Oligarchy in these Aristotelian deviant systems provided the widest base for involvement in public affairs. However, here too the political body was narrowed down to a very small circle of decision-makers. Hence, any oligarchy ends with a conflict, first among the oligarchs themselves and then between the remaining oligarch and the society. Triumvirates produce Caesars.

A narrow circle of those who make decisions in public affairs cannot indulge all social groups and strata and their myriad interests. For a while, it is possible to suppress interests using repression, but this will not annul them. What students in Chile wanted to do, for example, workers achieved by becoming the middle class through institutions of the economic system.[180]

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[179] Ibid, pp. 11-12, i.e. the Serbian issue p. 3

[180] Niall Ferguson, *The Ascent of Money* A Financial History of the World accoridng to the Serbian edition: *Uspon novca finansijska istorija sveta*, 2010,

III.1.3. Origins of the middle class

The more a social system is authoritarian, the smaller its political body. Therefore, such a system proves to be the most vulnerable. Numerous inconsistencies are inherent in society, which can be hardly resolved on a narrow base. The aspiration to become a part of the political body marks the political history of social communities.

For most of the history of social development, the political body was identified with the social elite, with members of the stratum of society which were granted the most rights and who consequently had the greatest impact on organization of society. The Hellenistic *πολει* were only individual glimpses of what was going to become *Senatus Populusque Romanus*. In ancient Greece, the political body remained linked to the governing stratus of society. Public affairs were the matters of the Senate, and only occasionally and at moments of social crisis, the support of the people was sought. This kind of support is outside of the usual system, and it is always clearly limited in time by linking it to the specific causes, the cessation of which terminates the involvement of representatives of a wider social community in public affairs. Quite contrary, the ruling stratum of society clearly constantly remains within the political body of a social community owing to its origin and acquired privileges. Such constant character differentiates it from those unable to participate in public affairs and who are therefore deprived of political rights.

Medieval cities and Renaissance Mediterranean towns were to replicate this pattern almost down to the smallest details. The same method was applied in organization of the political communes – the city-states of Genoa, Venetian Republic and the Republic of (Ragusa) Dubrovnik – to the late modern time. Although the same political body was comprised of a small number of the privileged by birth, these cities were considered at least partially democratic and were called republics.

However, in the course of the Middle Ages in other free cities there appeared a new separate political body, parallel to the general structure of the then-state. In this way an institution was created where at least two political bodies existed at the same time. The one was linked to aristocracy and completely identified with members of the social elite,

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ПлатΩ, Beograd, p. 212–219.

while the other, in cities, also connected to the ruling stratum; however, the qualification of a ruling party was not based on origin but on their efforts and skills. Merchants and people of business comprised this group, which historically represents the origin of democracy as we know it today.

These city elites derived their position of power from their business activities, and their position was strengthened by the legal protection of those activities. It appeared relatively early, as a form of self-regulation of relations and business among merchants in the *Lex Mercatoria*. Not more than a few decades later, the states in the late Middle Ages took responsibility for the legal protection of merchants and businesses, including the monopoly of power at its disposal. The Dušan's Code is a clear example of this, in the part concerning the central square/market and merchants and customs officers.[181] The state embodied in the Emperor and made operational in its office and the judges it appoints, takes on the protection of merchants from all who might jeopardize them, including the nobility. Verbatim, Article 118 sets forth:

'No nobleman or any other man shall forcibly hinder or seize the goods of a merchant treading on the lands of the Tsar, and money by force foist on them.'[182]

Markets (called 'trg' - squares in the Serbian Dušan's Code) thus become a kind of extra-territory, subordinated only to the power of the Tsar and his regulations, similarly to free cities in other parts of Europe: 'Merchants who trade in scarlet cloth and other necessary small and big merchandise, shall travel over the Tsar`s lands, to sell and buy, however commerce may require.' [183]

This still did not mean, nor could it have meant then, the expansion of the political body to merchants, or to miners, for example, who were the subject of special provisions of protection in the Dušan's Code and in the Law on Miners half a century later in the Serbian Despotate. Involvement in public affairs was still in the hands of the absolutist and

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[181] The Dušan's Code, Articles 118–122, www.dusanov-zakonik.com

[182] '*Trgovci, koji idu po carevoj zemlji, da nije vlastan nikoji vlastelin, ni koji bilo čovek silom im smetati, ili ščepati robu, a novac mu silom nametnuti.'*

[183] Ibid, Article 119: '*Trgovci i male i velike potrebne robe skrlata da idu bez smetnje po zemlji carevoj, da prodaju i kupuju, kako komu trg donosi.*

autocrat Tsar and the aristocracy. Yet, the special care for preservation of these activities is evident; and later on, elsewhere and in better circumstances, it served as the ground for the root of the middle class. Islands of different relations within one social system were created; and they were islands which would spill over their way of organization into the remaining part of society, completely changing its organization.

Likewise, the widening the political body in this period to encompass parts of the peasantry was not merely anything more than incidental occurrences. They did not happen due to political resources, nor could they be sustainable within the political body.

A larger, more decisive step forward started as an incident and continued with permanent repercussions – the inflow of silver from the New World. Those who brought it entered the body politic and remained there because of silver.[184] The riches fueled the rapid development of cities and their political elite. It contrasts with the Mediterranean Renaissance. While it also was based on riches, they came from the East, and silver's inflow from the West made it possible that the activities of the city political elites spilled over outside the medieval city walls.

At the level of the entire society a third stratum emerged – the middle class – conscious of its wealth, significance and influence. The political body, thus, for the first time included only the social elite; it widened to encompass the bearers of other interests as well.

The business activities of the middle class, the source of its power and influence, expanded to such a degree that special legal regulation was required. In contrast to the Lex Mercatoria, this was not self-regulation but regulation by the political elite. Louis XIV issued the Ordinance regulating retail and wholesale trade,[185] governing – for the first time – companies, banking, intermediaries, etc., in a way recognizable to us.

The contents of the Ordinance speak volumes of how the core activity of intermediaries and merchants became diversified. It regulates, in detail, complex trading and business relations, payment and debt instruments, instruments of capital, the organization of capital into two fundamental types of companies and their dissolution, including the

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[184] Pierre Vilar, *A History of Gold and Money 1450-1920,* according to the edition: *Zlato i novac u povijesti 1450–1920*, Nolit, Beograd, 1990

[185] *Ordonnance de 1673 edit du Roi servant de reglement pour le commerce des negociants et marchands tant en gros qu'en detail.*

disposition of assets. Thus a legal foundation was laid for the strengthening of the middle class and securing its position in the political body. Thereafter, it steadily grew, driven by its business activities, and expanded the political body of the social system for its members and their interests. Its position was strengthened to the point that it was able to defend itself by political and non-violent means. During the American and the French revolutions, the middle class continued to expand and defend its economic and political liberties. The notion of the political body, therefore, means the freedom of equitable participation in public affairs, finally wider than the concept of the political elite.

III.1.4. Three social strata

This expansion of political participation did not entail the abolition of the elite, or the absolute inclusion of all stakeholders. In fact, the redefinition of the position of social classes ensued, and new ones were created and repositioned in relation to certain social systems, including the one we recognize as democracy.

A mixed social structure is created, whereby the position of members of certain social strata, and their influence upon management of public affairs, is measured by economic power. Conditionally and roughly speaking, the middle class encompasses the central part of society whose main characteristic is that its economic power depends upon its relationship to capital relation and labor. A member of the middle class and his family live off an earned wage, but at the same they time generate sufficient income to invest it and supplement their income by an annuity. Such a position determines the entire *weltanschauung* of the middle class, affirming certain values to which it aspires. Democracy as a social system is best suited to such a position.

The middle class is surrounded by social strata to which democracy does not necessarily bring betterment, at least not in the short run, and which are not necessarily supportive of the development of democratic government. Any social system that provides jobs suits the members of the stratum dependent upon the income they earn by direct work, and whose earnings are insufficient to allow for making investments. Therefore, even a moderate dictatorship will satisfy the economic needs of the working class, as long as it does not threaten life and liberties;

though a dictatorship which does pose such a threat will push concern about employment into second place. A moderate dictatorship might last for decades and be stable, although it fails to provide minimum political freedom and excludes from public affairs all who are not members of a narrow political body organized around the ruling party. Former socialist Yugoslavia is a clear illustration of this.

The twentieth century overthrows and revolutions offer numerous examples of the creation of such social systems. In the beginning of post-upheaval phases, these social systems only seem to expand the political body. The decision-making about key issues is always set outside of the institutions, which serve only as a stage setting for creation of the illusion of involvement of the people, proletariat or another ideologically acceptable part of society in government. In these phases, by application of a proper distribution policy, the most numerous segment of the population becomes economically stronger.

These systems only can claim a more equitable division of the social wealth as their most favorable effect, but not expansion of the political body. Further, even this favorable effect is linked to their initial phases only. Once they are well-established in the newly-built institutions, the members of the new political elite exclude from their political body more and more members of society, and economic distribution begins to be founded on exploitation of their positions.[186] During the 1930s, for example, the gap between the top and bottom earners was higher in the Union of Soviet Socialist Republics, than in the USA.[187]

However, threats to democracy, overthrows and revolution should not be associated with only one social stratum exclusively. Even when there are no social overthrows, when societies develop in the wake of general technical and other forms of progress, it does not automatically mean that the political body will be widened or the management of public affairs improved. Quite correctly, Jose Ortega y Gasset saw the entire 19th century as a period during which general progress brought a series of technical improvements in life which resulted in the establishment of a significantly different society.

Many social hardships and concerns about basic economic survival

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[186] George Reisman, *Politika protiv privrede*, Global Book, Novi Sad, 1998, pr. 390–397

[187] Hayek, ibid.

were alleviated and general health conditions were improved. Political freedoms, and the legal framework to protect them, were expanded, as institutions were built whose primary aim was the preservation of the rights of any member of a social community.[188]

Still, Ortega y Gasset, states resignedly: 'the majority of men — and of women — are incapable of any other effort than that strictly imposed on them as a reaction to external compulsion'.[189] The political body will not follow this path of expansion unless general social progress is followed by the progress in the mind of individuals. Even Ortega y Gasset does not; there is no mention of a person as an individual person but of a person in the mass of people – the mass man, as he does not separate himself from the mass.

Therefore, management of public affairs will not come into hands of a larger number of interested persons, as they, although having the opportunities are not interested – the mass-man is characterized as 'the mediocre man of our days' and further on the 'innate hermetism of his soul' is mentioned. He is incapable of critical thought and comprehension of the world he lives in, as 'it never occurs to the mediocre man of our days to doubt of his own plenitude [...] His self-confidence is, paradisiacal'.[190] Therefore the mass men cannot act as individuals but only as part of the mass, with other members of society, similar to them only what Ortega y Gasset calls the 'revolt of the masses'.

Ortega y Gasset generally is disappointed by the discrepancy between the general technical progress and stagnation, and what he sees as the regressing of society, sharing the same concerns expressed by Dewey and Olson. Dewey emphasized the necessity of special upbringing and education, which would socialize members of the social community as responsible individuals with citizens' merits. Olson explained that nothing will happen in a community, no matter how developed, that would enhance the greater good if community members do not have an incentive – positive or negative – to engage in public affairs. Ortega y Gasset clearly differentiates between education and upbringing. The nobility was brought up to feel social responsibility, whereas the mass

[188] Hose Ortega y Gaset, *The Revolt of the Masses*, according to the Serbian edition *Pobuna masa*, Gradac, Čačak, 1988, p. 73

[189] Ibid, p. 73

[190] Ibid, p. 75–81

man, in spite of his knowledge obtained by education, is not capable of using the knowledge for greater good.[191]

Ortega y Gasset had before his eyes the post-revolutionary societies and dictatorships between the two world wars. He was compelled to criticize the prevailing illusions under which they operated: that some of the basic contradictions were resolved, contradictions which democracies actually had not been capable of resolving; and achievements in economic efficiency. It had been confirmed many times over (by collapses of systems and theoretical rationales of the collapses), that in the long run, the opposite is correct. Such an organization of society was inherently economically inefficient, and it could survive only by consuming itself[192, 193] or by incurring massive indebtedness. Once the resources are depleted, the national idyll comes to an end, and the economy collapses, followed by the entire social structure.

Obviously, democracy cannot be regarded as something that automatically ensues with the progress of some segments of the society. It cannot be established as a social system without relevant social institutions, without institutional procedures that make it possible for a large number of interested persons to be involved in management of public affairs.

However, this alone is not sufficient. Even when political rights are expanded to all major elements in a society, this does not necessarily mean that they will be interested in exercising their rights.

This requires a special form of upbringing and education, but also the interest which will compel the members of a community to directly engage in enhancing the greater good, or at least the part of the greater good in which they are directly interested. On the other side of the middle class, there is a stratum which rests its economic influence on investment of their own capital. This does not necessarily mean that members of this stratum are not directly committed in daily operational activities. However, regardless whether they manage the capital on their own or let professionals do it, their income comes primarily from their capital relation and not from their labor.

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191 Ibid., p. 70–73

192 Hayek, ibid, pp. 97–112

193 Reisman, ibid., p. 319–355

At first glance, the turnover of capital can be facilitated independently of the social system. Major capital exists even in dictatorships, and in some countries, such major capital had brought the dictator into power. In certain circumstances, it might be suitable for capital and its representatives that circumstances become stable even by use of political means, though such benefit is short-lived. Prolongation of dictatorship threatens all those who are not in the narrow circle of persons making decisions that concern public affairs. Nazi Germany is a prime example; for business owners and industrialists, what the representative of the ruling party thought about their business logic took precedence over market forces.

As is the case with the earlier comparison between dictatorship and demagogy, here the same spot is reached, though the departure points were on the opposite sides. When the political body is narrowed, all representatives of a society suffer in the long run, regardless of their social stratum.

III.1.5. Marginal groups of society

Let us reiterate that this division into three strata was drawn conditionally speaking and only roughly. Contemporary theorists stress that in addition to these fundamental strata there are numerous strata standing in between, and at least two strata on the opposite margins. On one of the sides, there are completely impoverished members of society with no regular income. On the other side there are holders of capital which once occupied a position right next to the middle class. However, now this spot has been filled with professional managers of capital who have become so numerous that they form an entire social stratum by themselves.

Although it seems a paradox, both socially-marginal strata, the poorest and the richest. are equally excluded from daily participation in social developments. What differentiates them is their potential to exert economic and political influence as the managers of capital increasingly dominate the shaping of social processes.

Christopher Lasch unequivocally separates this social group into a new stratum, explaining it in his work *The Revolt of the Elites and the Betrayal of Democracy*:

'These groups constitute a new class only in the sense that their livelihood rests not so much on the ownership of property as on the manipulation of information and professional expertise. Their investment in education and information, as opposed to property, distinguishes them from the rich bourgeoisie, [...], and from the old proprietary class—the middle class.'[194]

This new professional and managerial class composes the majority in the top twenty percent of wage earners in the United States of America.[195] Its origins may be traced back to limited partnerships,[196] and even earlier. Among notarial documents in the Archives of Kotor, there are records from as early as the thirteenth century regulating relationships between those who entrust their capital to others who manage it.

In modern times, clear and widespread disconnect of the capital owner from the managerial function began with John D. Rockefeller's formation – in the late ninetieth century – of a board of trustees to whom shareholders of companies owned by Standard Oil entrusted their shares for management.[197] This structure was rapidly embraced and duplicated in different variations and legal forms. Similarly, investment funds were formed, managed by special legal persons – management companies – employing professional capital managers.

According to Lasch, members of this class are positioned between the traditional middle class and those living off the income from capital, and they threaten each other equally. The threat spreads in two directions – towards the inner, national, social being, and at the international level.

At the national level, it suppresses members of the traditional middle class with all of its features: clinging to family values, respecting other people's possessions, the imperative of diligence, aspiration to stability. The goal of the middle class is not acquisition for the purpose of

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[194] Cristopher Lasch, *The Revolt of the Elites and the Betrayal of Democracy,* the Serbian edition *Pobuna elita i izdaja demokratije*, Svetovi, Novi Sad, p. 1996, p. 36–37.

[195] Ibid., p. 35

[196] *Ordonance, la société en commandite*…

[197] Vesna S. Aleksić, *Sjedinjene Američke Države i velika svetska ekonomska kriza 1929–1939*, Stubovi kulture, Beograd, 2010, p. 38.

acquisition, but acquisition for economic security and independence.[198]

Concurrently, and also at the national level, this stratum separates the owners of capital from what the capital embodies. Professional managers manage the process in which property owned by someone else is transformed into capital. The turnover of capital is in their hands, and they give it its main characteristics.

Here Lasch is on the right track. The position acquired within a society, and its potential for exerting influence, is used by the members to hinder and halt social progress, including social mobility – a feature so important to democracy – thereby ensuring the constancy of their positions and their remuneration.

Lasch was not the first to notice the existence of this stratum; he merely linked it to a specific moment in the development of society and economy. Lasch recognized it as a whole, formed stratum with its own system of values and its own model of life. Max Weber, speaking more generally about different groups in society, prior to Lasch, described and classified the features attributed to the managerial class. He linked them to a separate social group – a status group. Instead of positions in economy, Weber bases the status situation on cultural characteristics.

'[...] we shall use the term status situation,' Weber says, 'to refer to all those typical components of people's destinies which are determined by a specific social evaluation of 'status', whether positive or negative, when the evaluation is based on some common characteristic shared by many people [...] social status is normally expressed above all in the imputation of a specifically regulated style of life to everyone who wishes to belong to the circle.'[199]

Although the starting position is different, Weber's conclusions have clearer economic implications. He points out that '[...] status differentiation goes together with monopolization of cultural and material goods and opportunities [...]';[200] and he notes that forming and maintaining a social group which has the characteristics of a status group, like managers of capital in the modern society, has as a consequence – '[...] the restraint imposed on the free development of the

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[198] Lasch, p. 67

[199] Maks Weber, *Selections in translations*, Cambridge University Press, 2007, p. 48–49

[200] ibid., p. 52

market'.[201] This leads to the detrimental effect of restraining the market and suppressing the rights derived from the fundamental right to property, if status interests overpower the interests of the entire society. In Weber's words: '[...] the power of naked property as such [...] is held back'.[202]

The phenomenon first described by Weber, and then expounded by Lasch, is a phenomenon we experience today. This stratum/status group of managers was the one that (influencing the representatives of the political elite) steered the changes in legislation of the capital market in the United States. They succeeded in winning the effective repeal of the Glass-Steagall Act – which had spurred the wide dispersion of investments into securities and protected retail investors – and adoption of the Sarbanes-Oxley Act, which favored the concentration of financial capital managed by highly-qualified managers.

Even the global financial crisis could not endanger the position of this stratum. Although the crisis has exposed the deficiencies of such a system, its burden has fallen mostly on the middle class, contributing to its further weakening and pauperization. Meanwhile, the power of the higher managerial class remained intact, despite the media reviling. Thus, one of the foundations of democratic and free societies – private ownership – was undermined; those who were the owners of capital before the crisis lost their property, while managers continued to receive their remuneration nevertheless.

Lasch links the globalization process to this stratum too, as limited markets are not in their interest.[203] The managers of capital seek the free flow of capital and the widest possible setting for its turnover. Their existence is based on the turnover, and they require expansion which brings about more opportunities for turnover. A particular social system and democracy are irrelevant to them. Whether an aristocratic system, oligarchy or dictatorship prevails in country is of no relevance to them as long as the free flow of goods and services is guaranteed.

Thus, the stratum found itself torn from the national social setting; it is cosmopolitan and grouped around the world financial and trading centers. Like the citizenry of free cities in the Middle Ages, today's global

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[201] Ibid., p. 53

[202] ibid., p. 54

[203] Lasch, p. 49

managers of capital effectively function on islands unto themselves, with different organization, different values, in a different prevailing system which under their active and aggressive influence changes more and more.

III.1.6. The middle class

The middle class is determined by work and capital, the two categories that underlie its existence.[204] The middle class, understood in such a way, fits well into the Weber's contention that three cumulative conditions were essential for its formation as a separate social group:

'[...] (i) a large number of men have in common a specific casual factor influencing their chances in life, insofar as (ii) this factor has to do only with possession of economic goods and the interest involved in earning a living, and furthermore (iii) in the conditions of the market in commodities or labor.' [205]

What separates the middle class from the rest of the classes in society is that it is associated with property and its enlargement, with work transforming property into capital. This is the class of entrepreneurs, regardless of their members' level of education. For example, a physician employed in a government service and who has a house which he uses as a weekend cottage or a summer house will not behave as a typical member of the middle class. On the contrary, a physician who owns a house, but uses it as a space where he practices medicine privately, belongs to the middle class in the full sense of the word. The same is true with a family of car mechanics whose members have, over several generations, accumulated enough funds to create a solid portfolio on the stock exchange, but still continue to run the mechanic business.

Contrary to what the Marxist theoreticians claimed, the middle class provided progress to society – economic progress and any other advancement for which the economic progress is a precondition. This is the class whose existence was founded on constant transfers of their property into capital, ensuring economic progress to themselves and to

[204] Lasch, p. 57.

[205] Weber, pp. 43–44

society from job creation – which is necessary for the capitalization of property in different activities – to the payment of taxes required for the fulfillment of the social and other functions of the state.

This is unequivocally stated by Weber: 'It means that only those who own property have the possibility of shifting what they own from the sphere of benefit as 'wealth' to the sphere of employment as capital: hence they alone can become entrepreneurs [...]' [206]

This role of the middle class signifies it as a necessary part of any society that wishes to progress. Its existence is the key for the betterment of the entire community, as its activity exerts positive effects on the development of society as a whole. In addition, a new investment is an issue of calculating different economic parameters, i.e. the risk and profit primarily to members of the large capital stratum. For members of the middle class, investing and developing a business is a question of maintaining and improving the standard of living for one's own family.

For members of the large capital stratum, acquisition is a profession and a way of life; whereas for members of the middle class, acquisition is the way to attain economic independence and a comfortable living. However, a member of the large capital stratum needs not to invest, while a member of the middle class is compelled to do so, otherwise he is in a no-win situation. Therefore, the paradox exists that large capital is much more cautious and conservative in operations on the financial market than the middle class. Hence the middle class, by employing individual small savings, provides the necessary depth to the financial market.

The position and the role of the middle class made it possible that a system of values developed with their representatives, a cultural model which emphasizes respect for family values, adherence to laws, diligence and industry, thrift, keeping one's own property carefully and respecting the other people's property. Stephan Zweig describes this cultural model as an ideal of members of the middle class, in his writings about the golden age of the middle class in the Austro-Hungarian Empire, right before the World War I. The time and place may vary, but the description of the mentality and the way of living of the middle class remains precise and true.

[206] ibid., p. 44

'The rights which it (the state) granted to its citizens were duly confirmed by parliament, the freely elected representative of the people [...] Everyone knew how much he possessed or what he was entitled to what was permitted and what forbidden. Everything had its norm its definite measure and weight. He who had a fortune could accurately compute his annual interest [...] When the babe was still in its cradle, its first mite was put in its little bank, or deposited in the savings bank, as a 'reserve" for the future. [...] Annuities were purchased for one's old age, and a policy was laid in a girl's cradle for her future dowry.'[207]

The aspiration of attaining stability and comfort necessitates the active method which members of this class must employ in their approach to economic life. This approach illustrates the fact that democracy in essence is best suited to the middle class, which is driven to actively participate in management of all public affairs of its direct concern. However, this will not remedy the fundamental constraint of democracy mentioned at the beginning of this chapter.

Any member of a society, the middle class included, will become interested in public affairs when some immediate effect is expected. Economic interest will motivate all who recognize it to participate in the work of institutions of the social and the economic system. However, without economic interest, or at least without a clear recognition thereof, important public affairs might be resolved in a way which is not suitable to the community, because, as Olson would put it, members of the community have no incentives to participate.

Still, this deficiency in democracies does not mean that other, undemocratic social systems should be sought and imposed. In a democratic system with publicly-managed procedures where the outcomes suit members of the middle class, the outcomes would suit other members of the society regardless of class. The fundamental protection of property, life and freedom provided by any democratic system diminishes discrimination of any kind and increases an equitable protection of all.

On the contrary, dictatorships, whether of the left or the right, mainly assault the middle class first, separating it from its property – which the basis of its existence – to more easily subjugate the entire

[207] Stefan Zweig, *The World of Yesterday*, according to the Serbian edition *Jučerašnji svet*, Službeni glasnik, Beograd, 2009, p. 14.

society afterwards. Hayek in *The Road to Serfdom* pointed out that a member of the middle class equally was an enemy to the Nazi regime in Germany and to the socialist regime in the Soviet Union.[208] Upon entering Belgrade in 1944/45, the forces controlled by the Communist party burnt the entire archive of the Belgrade stock exchange, which contained shareholder records, to destroy any evidence of ownership. The same was done in the Soviet occupation zone in Germany, where one of the first directives by the commanding officer of the occupation zone was to collect and destroy securities certificates.

The democratic social system, with all of its institutions and procedures, is the best defense of fundamental values, upon which the entire society and its strata rest. When the middle class is neutralized, and its institutions destroyed or transformed, the road is opened to violence against all members of society.

The democratic society is based on interests, and necessarily so, otherwise it would not be able to function. Interests gather its members around certain public affairs and engage them in their management. Therefore, it is necessary for the development and sustainability of democracy that the economic interest be as wide as possible, i.e. that the largest number possible of members of a democratic society has and clearly recognizes its interest. Acknowledging the economic interest, members of society will make the effort to determine the ways in which they can attain it and provide it. This inevitably leads to the political sphere and into the management of public affairs. A member of society with clearly-defined economic interests enters the political body of society.

The development of the capital market is one of the ways to most easily expand the political body as a precondition for the functioning of democracy with the most favorable effect on the entire society and its economy. Institutions of the capital market are committed to the protection of private property in the form of securities and, their continuing turnover as well as the constant capitalization and the conduct of affairs occurred in the process of turnover. They can quickly and simply facilitate the possession and free management of property for the widest circle of people. The distribution of shares of the state companies in Serbia in 2010 and 2011 speaks volumes. A total of 4.8

[208] Hayek, ibid.

million adult citizens in Serbia were allotted an equal number of shares of the Naftna industrija (The Oil Industry), and then Aerodrom Beograd (The Airport Belgrade). As opposed to other mass privatizations in other transition countries – of which the Czech Republic and Slovakia stand out as notorious examples – capital market institutions in Serbia already had been established and were fully-functioning. The daily turnover reached between fifty and eighty thousand shares, hitting a record daily high of two hundred thousand shares. All shares changed hands on the Stock Exchange in a proper manner and were appropriately registered with the Central Securities Depository.

In addition to good functioning of institutions, the good behavior of shareholders was also noted, in contrast with other privatizations. While in other privatizations, and at the beginning of the transition process in Serbia, when institutions were still underdeveloped, shareholders were reluctant shareholders, wishing to sell their shares as soon as possible and get cash. However, they behaved differently with the privatization of the Naftna industrija and Aerodrom Beograd. There was no rush to sell shares, and even the takeover bid extended by the majority owner of the Naftna industrija (Oil Industry) was responded to by less than six percent of shareholders. Does this mean that shareholders embraced the values of the middle class and started to regard this property differently? That consequently they themselves have become the middle class? It is still too soon to claim, but these examples suggest development in this direction.

The Serbian case also demonstrates the parallel between the capital market and the democratic arrangement of society. The democratic system is inherently constrained if there is insufficient economic interest among those who should participate in it. In addition, the constraint comes from the aspiration of certain social groups to suspend social mobility at the moment it suits their takeover of social institutions.

The capital market will facilitate the simplest possible expansion of the middle class and the development of middle class economic interests. For example, a person living in the city of Niš need not be interested in what happens in Subotica. However, if he has bought shares of a company in Subotica, he will most certainly be interested. If a company is agricultural, which is easily possible in the case of Subotica, then his interest will expand to how the government runs agricultural policy, and he will consequently form his political views. The capital market, therefore, provides what Olson sees as a missing factor – selective incentive for involvement in management of public affairs.

Once the market is developed and deepened, capital market institutions will help ensure that all processes associated with the largest part of the available economic values in a society occur publicly and pursuant to the set rules. There are no larger obstacles than establishment of remuneration on the basis of a position in an economy and society. The public follows the rules that apply to all, eliminating exclusivity in decision-making and, therefore, preventing the ability to earn profit from exclusivity. Takeover bids for shares publicly traded on the stock exchange eliminates corruption which could develop in the process in which individual branches of government administration make decisions what, how much and to whom to sell.

The principles of organization and functioning of the capital market largely overlap with the principles of organization and functioning of democratic institutions. Of course, some differences do exist, but their essence remains identical. Hence the active participant in the capital market easily fits into the democratic pattern of management of public affairs, and the development of the capital market is one of the preconditions for sustainability of a democratic social system.

PRINCIPLES OF ECONOMIC AND POLITICAL DEMOCRACY

III.2.1. Openness of institutions

The way in which a social community will be formed, in what manner the management of communal affairs will function and what the scope of the political body will be are all intertwined with the prevailing economic organization in the society; and they affect each other to a great extent. The capital market exerts extremely strong influence on the organization of society and its institutions. If it is formed on wide foundations, available to a large circle of the potentially interested persons, the prospects are that it will be reflected on the expansion of the political body and thus improve the democratic capacities of society.

However, hindering or abolishing capital market institutions are early signs that the social system has turned in an undemocratic direction. Inasmuch as in order for democracy to function as a regulated system of societal organization, to be efficient and provide sustainability and development of a social community, the same is necessary for the functioning and development of the capital market. First, private property must be clearly defined and all rights attached to it to protect it by different legal postulates at the level of social relations, in the constitution, or in systemic laws. In addition to private property, the same approach is required for the protection of the right to liberty and life. This is necessary for democracy as the foundations supporting the entire construction of society. These constitutional categories find their unique expression in economy and on the capital market, with equal weight for its organization and development.

The application of the postulate safeguarding the three key categories is transferred to the network of institutions. The institutions would have to work following the procedures clearly defined and known in advance to all prospective participants in processes administered by these institutions. For a democratic development of society, it is equally important that the stock exchange is organized in such a way – as an institution of the financial market – as well as courts or representative bodies, from the local to the national level. If this is not the case, if the procedures are familiar only to some individuals, some social groups or some social ranks, they will be the exclusive recipients of remuneration from the market. Further, as Weber puts it, they will monopolize the approach to their (privileged) group and therefore jeopardize, and in the longer run, most probably shut down the capital market and the essential functioning of democracy.[209]

Ron Chernow confirms this in his work *The Death of the Banker*[210] about the connection between the political and the economic at the level of the organization of society and economy:

'When political elites scorn and manipulate the masses, corporate elites will likely exhibit parallel contempt for shareholders; in despotic societies, power tends to be concentrated at the top in both political and economic institutions. Take away political democracy, and shareholder democracy is far less likely to flourish. As a rule, democratic societies will curb unbridled power exercised jointly by bankers and corporations. By the same token, democratic societies will find shareholder democracy [...] highly congenial and compatible with the general rules of the political game.'[211]

Further elaborating upon the thesis, Chernow notes it is not peculiar that political and economic oligarchies merge in relatively early stages of industrial societies. These societies are characterized by a shortage of capital and the greater need for a rapid industrial development, as well as a general shifting of social strata. However, as the

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[209] Weber, p. 281

[210] Ron Chernow, *The Death of the Banker*, Vintage Books, New York, 1997

[211] „When political elites scorn and manipulate the masses, corporate elites will likely exhibit parallel contempt for shareholders; in despotic societies, power tends to be cocentrated at the top in both political and economic institutions. Take away political democracy, and shareholder democracy is far less likely to flourish. As a rule, democrartic societies will curb unbridled power exercised jointly by bankers and corporations. By the same token, democratic societies will find shareholder democracy… highly congenial and compatible with the general rules of the political game.”, Chernow, p. 52

institutions grow stronger, constant clashes occur between the oligarchs and representatives of the economic and social forces which suffer from the actions of the oligarchs which impede their further development; and this dynamic makes the society and economy more and more democratic.

However, this is not an inevitable train of events. The 'progress' made in the 19th century, after it occurred, was viewed as an unstoppable force bringing nothing but the betterment to everyone.[212, 213] On the contrary, Chernow – citing the US development of a 'model of transparent financial markets and shareholder democracy',[214] – demonstrates that only societies which have started to establish and set up democratic and market institutions succeeded in developing democratic systems. The societies in the late-19th century and early-20th century which did not cultivate these institutions failed; their members were denied the benefits of democracy and open markets, and the societies generally slid into totalitarianism with pernicious effects.[215]

If there should be a single word for what links the development of the capital market and shareholding with the development of democracy in a society, the word would have to be openness: openness of institutions, openness of all structures, and openness to influences that might be exerted from their environment. The influences must be in a way institutionalized and standardized, to avoid the dispersion of their effects beyond recognition. This is done through the institutions of the system, economic and social, defining the procedures for actions, thereby receiving the influences themselves. For example, demand and supply are determined on the stock exchange in a certain defined way, and this is executed according to predetermined procedures, exactly as there are procedures for submitting a bill to the parliament, or a complaint by citizens.

Procedures are what safeguard the openness of the institutions, and therefore the functionality of a democratic system, be it as a political democracy or an economic system. In order to facilitate what Hayek and Olson spoke about when emphasizing the necessity of incentives in public affairs, the procedures must be balanced so as to attract

[212] Ortega y Gaset, p. 73

[213] Zweig, p. 15–17

[214] Chernow, p. 52

[215] Ibid., p. 52

potentially interested persons to follow them. They must utilize individual incentives to resolve public interests. Consequently, it is necessary to embody in the creation of these procedures a few simple and basic – but therefore even more important – principles which undergird both a democratic social system and the economic democracy of shareholding.

III.2.2. Anonymity and Transparency

Shareholding and democracy both function on the basis of ensuring anonymity for those who directly participate in the process and the transparency of the work of elected officials. Therefore, from the standpoint of an individual, the process is anonymous, and from the standpoint of the group, it is public.

Every individual participant is protected in this way, while participating in the process, to the moment the participation potentially leads to taking over a public position within an institution of the system. Anonymity spurs freedom to act, and transparency compels control of joint positions. Therefore, every institution is inevitably public; and a decline in the transparency of its work unavoidably brings collapse of the system, or indicates the implosion has already begun.

It is possible for an individual, within a system, to become an institution for itself. There are numerous examples to support this, when it comes both to economic and political democracy. It is important to realize that even when an individual makes an institution, the institution has to be public to conform to shareholding or democracy.

Privatization of an institution, its exemption from public control and accountability, and its subordination to personal instead of subordination to the interests of the group, separates the group from the standards of democracy. Abundant examples exist in politics, but also in economics. One of the examples is The American financier J. P. Morgan is one example of an individual also being an institutions. His extremely undemocratic actions, covert and away from the public eye and any control, had to retreat in the face of economic democracy institutions;[216] as a confirmation of our assertions regarding linkages between economic

[216] Chernow, pp. 87–106

and political democracy. These economic democracy institutions, which up to then had not controlled the work of the almighty 'investment bankers' on the US market, were established in the process of expansion of the political democracy in the US during the early 1930s.

There also are some examples closer to us in terms of both time and space. The most conspicuous are the present tycoons in Serbia and in Croatia, who demonstrate how connected economic and social systems are. Lack of democracy in one of the spheres would immediately imply absence of democracy in the other. The phenomenon certainly requires a separate study, as those who the public, created by the political elite, recognizes as tycoons with all the negative connotations implied in these two countries, are actually representatives of large capital.

They have acquired their wealth in the course of transition in a lawful way, transparently, meeting their obligations to the state and the stakeholders flocking around the companies they manage. Concurrently, the public is completely unaware of the activities of anonymous 'controversial' businessmen, who, in tandem with the political elite, have acquired a large number of companies which they do not know how to manage. All the social ailments of a transitional society are mainly a product of the latter.

On the contrary, the former, the publicly infamous, bought the companies to manage them and make profit in this way. The clandestine businessmen, out of the public eye, were focused on extraction of capital and then the sale of ex-companies as a set of real estate items. The former increased the number of jobs and the latter left all the workers jobless. Finally, the fact that companies of the representatives of the large capital on the Belgrade Stock Exchange are considered to be blue-chip companies confirms our postulate on the applied principles of anonymity and publicity. If there were times when they lost some of their value after the takeovers, it was only because of the economic crisis. The companies managed by the latter, without the public, were statutorily required to be quoted on the stock exchange. However, their value constantly declined, until depleted to the end of their liquidity.

Control, as something that should be made possible by the principle of the transparency of work of institutions, is exercised by voting, both in political and economic democracy. In this case, general meetings of shareholders are equivalent to representative bodies of political society. Shareholding, however, introduces a supplementary institution to the system – the stock exchange. Public and transparent trading on a regulated market, with strictly defined procedures, signals the level of shareholder confidence in a joint-stock company's management.

Selling shares is a negative vote, and if it is higher than demand, it leads to a drop in prices and often a potential management crisis. The reverse goes for purchase of shares. Thus, the stock exchange becomes an institution of economic democracy. It is possible to signal confidence or lack of confidence in management of all listed companies, at any moment. Moreover, the voting process is no longer confined only to general meetings of shareholders. It almost gains a character of a referendum; purchase of shares in 'positive voting' is available to all through stock exchange agents.

Niall Ferguson asserted in *The Ascent of Money* that, '...stock markets hold hourly referendums on companies whose shares are traded there: on the quality of their management, on the appeal of their products, on the prospects of their principal markets.'[217]

Such 'voting' is transposed to an expression of opinion regarding management of economic policy in general. A general attitude to market stability is also available, owing to open purchase and sale of stock exchange indexes, all created on the basis of the basket comprising the most representative shares. The growth of an index signifies trust, and a drop in its value indicates the opposite. In the same way, what goes for the stock exchange indices goes for treasury and municipal bonds.

A widely-distributed bond issue will have an immediate effect on the increase in the transparency of the work of government institutions, especially in the segment concerning the implementation of economic policy.

Chernow mentions a significant example in the US, explaining that treasury bonds had the key role in education of population concerning the capital market:

'Because the U.S. government financed its war involvement through Liberty Bond drives that netted billions of dollars, it tutored millions of Americans in the virtues of securities. In this way, the government began, quite inadvertently, to wean the country away from the old bankbook style of thrift to the more glamorous but volatile regimen of stocks and bonds.'

In this way, bonds attracted wide investment public through the institutions of the capital market, providing knowledge of securities to

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[217] Ferguson, p.126

the public, all that should be known and also forming the interest in the government economic policy with the public via the securities. Chernow correctly considers this period a turning point in the development of the American market; and, one could add, the further development of democracy, as well.

III.2.3. Freedom of association

Freedom of association is one of the key principles for democratic organization of a community. In advanced shareholding, it appears as one of its postulates, as well. Weber recognizes it as such in his book *Economy and Society*. He sees the freedom of association as a precondition for the creation of a community that will surpass the mere association. In his opinion, this is what happens with the joint-stock companies that undertake joint activities without the prior relevance of the personal traits of those who are to jointly act. Weber explains that a person might become a shareholder regardless of personal human characteristics, and as a rule, without the knowledge or approval of other shareholders, simply based on an economic transaction.[218]

Generally, formation of joint-stock companies is not hindered anywhere, just as it was not hindered when the first merchants joined in specific commercial ventures. However, it is important to recognize where it becomes indirectly restricted in shareholding, since it might imply deeper disturbances.

There are certain business activities any political community would like to protect and control. Depending on the manner in which the social community is organized, these activities occur more or less frequently. An authoritarian regime has a higher number of shielded activities, in contrast to open democratic societies.

Protection can be provided in different ways, and when it comes to joint-stock companies, it actually implies restriction of free association. For example, there are restrictions saying that foreign natural and legal persons are not allowed to possess majority ownership in companies providing informational services, production of military equipment and other sensitive sectors. Such restrictions are set by the state. They were

[218] Weber, p. 283

characteristic of the entire period of the socialist Yugoslavia as a restriction on the mere ownership, since the social Yugoslavian system did not recognize a joint-stock company as a form of capital organization. Even after the statutory provisions were in place for the formation of joint-stock companies, right before the end of the state, restrictions remained and lasted to the end of the 1990s, being applied to the joint-stock companies with this activity, too.

Restrictions also might be present at the level of the joint-stock companies. Lack of understanding of the fundamental shareholding postulates might lead to imposition of charter provisions in joint-stock companies, requesting a person to grant approval for the sale of shares. Such a requirement would be outside of the person's scope of work, e.g. members of a company management body or the manager himself. This is how new shareholders are controlled. If the management dislikes the new shareholders who bought the shares, they will simply cancel the sale. An established structure of a company that has appointed the management becomes virtually impossible to change.

The practice was common with almost all the banks in Serbia to the time of the changes introduced with the fall of 2000. Paradoxically, once the restrictions were removed, when the shares were freely traded on the Belgrade Stock Exchange, the shares of the bank that had had the most restrictive statutory provisions regarding the transfer of ownership – imparting the discretionary right to the general manager to approve it or not – became one of the most traded shares. The bank management adapted to the new circumstances, successfully leading the bank to an expansive business strategy in the following decade.

In spite of the restrictions that abolish freedom of association as a principle, there are restrictions aiming to provide general access to enjoying it. These are a set of rules and procedures prescribed by the authorities supervising financial markets, which pertain to protection of interests of small investors.

For example, a company may be required to provide notice of a takeover, implying the entity making the offer must afford equal treatment to all shareholders, even after an eventual purchase of the controlling block of shares. Two other examples are investment restrictions imposed on investment funds prohibiting investment over a certain percentage of capital in a company, or an obligation of investment funds to keep a specific part of their portfolio in government securities.

III.2.4. The mass-society character

Democracy, whether economic or political, is fully realized when in attains, to the highest extent possible, its mass-society character – and not just for the abundance of (fictional) participants. The masses who are unaware of the consequences of their action, are pulled into the institutions of the system, rather than led to 'demagogy' (as Plato contended) and undermining democracy.

The mass-society character that lends the true quality features to democracy, must be attained by association of conscious individuals, clearly oriented and motivated. These individuals must comprehend their environment as a starting point; wish to change it, to define a goal and to identify other similar individuals, with whom they finally associate. Transition countries that opted for mass privatization faced a problem called reluctant shareholders. Those who were given their shares for free, without making a decision to invest in a joint-stock company by purchasing its shares, had no motive to keep the shares. When the first opportunity arose, they sold the shares, accepting the first price offered, taking refuge in cash, which was the property they recognized.

Education may fuel significant change in such behavior, but it was an option to which few transition countries resorted. Competent institutions addressed different circles of the public by a series of educational shows, leaflets, courses and seminars. Both the widest public and specific groups – such as police and prosecutors – were targeted to help facilitate the protection of shareholder rights. Poland was recognized as making one of the most successful of all transitions. Likewise, capital market regulators in Croatia and Serbia organized different activities on raising investment awareness.

Interest is the best teacher. In situations when one could earn money by keeping a share instead of selling it promptly, shareholders were quick to realize what the most lucrative course was. This is the same as in the example of American bonds, quoted from the book of Ron Chernow,[219] with the first principle of anonymity and publicity – only a step from assuming an active role of an investor on the capital market.

Weber too gives priority to economic interest in a community before an ideological motive to stay in it. It is as if he describes a joint-

[219] Chernow, pp. 40–41

stock company when saying that if a group of people pays someone to constantly and thoughtfully take care of all mutual interests, then the people would associate; and such association, under certain circumstances, is a strong guarantee that such activities would last. [220]

Still, it is necessary to build a procedure for adoption and implementation of decisions, which would protect every individual of the environment and their interest, making the positions public. The quality of the procedure is to give a final democratic appearance to an association or a community.

The consciousness of the goal, the first motive for joining the association, imparts a working character to it. The association was created in order to pursue a goal, and the act of joining it implies active opting for the environment. Joint-stock companies are entered by purchase of a share, but with a political community, we cannot speak of such joining, since everybody is already in some kind of a community, at least in the widest one. Joining, in this case, should be understood as engagement in political life as the political body.

Political communities have always demanded from their members some experience and credentials attesting to the individual's competency to participate in a public, political process. The examples for this can be found in automatic grant of suffrage by reaching the adult age, in property requirements for the right to vote, and the former requirement to understand the constitution in some US states. The latter, since it was primarily a means for eliminate poor and minorities from political process, shows also how every principle could be easily twisted in its opposite, if not properly protected.

Joint-stock companies can demand prerequisites, too, as a proof of someone's qualification to participate in the work of the general meeting of shareholders. This is reduced to holding a certain block of shares, since it is understood that everyone with such a block of shares is interested in the welfare of their company.

In any case, political and economic democracy consider an active and responsible attitude of participants and timely information about the ongoing processes in the environment to be essential prerequisites for the best possible functioning of the system and effective decision-making.

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[220] Weber, p. 282

III.2.5. Division of responsibility and risk

Entry into an organized community involves acceptance of certain rules and procedures the community rests on, as seen with the previous principle. Activity in a working community with a clearly-defined goal leads to a new separate principle – division of responsibility and risk – which also enables application of the previous principle. Hayek insisted that 'the economic freedom [...] is a prerequisite of any other freedom' and also that freedom '[...] must be the freedom of our economic activity which, with the right of choice, inevitably also carries the risk and the responsibility of that right'.[221]

Without economic freedom there is no political freedom either.[222] In everyday life, freedom is reduced to the right to chose and it cannot be exercised without a certain risk entailed and responsibility for the decisions or choices we make. Aware of it or not, each member of society or a political community bears his share of responsibility for its development, and his share of the risk. Political organizations, institutions of a political system and parties and movements in developed democratic communities provide abundant opportunities for undertaking such risk, and further adding to the development of the communities.

We will focus on the economic aspect of the principle's application, that pertaining to shareholding. Joint-stock companies are formed because of the need to divide risk in an economic venture. Greater participation in a joint-stock company implies greater exposure to risk and, consequently, higher responsibility for it. Therefore, it is only reasonable that the one with majority ownership in a joint-stock company has the controlling power to decide. Corporate charters often declare in their provisions regarding cumulative voting that a certain percentage of ownership will ensure a seat on the board of directors.

This seems like a clear and just rule. If someone invests more in a community, it seems that there is nothing debatable in the fact that the voice of this person should carry more weight than that of those who invested less. A larger investment entails a higher risk, and a higher risk implies that the one bearing it should feel more responsibility for the

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[221] Hayek, pp. 110–111.

[222] ibid, p. 110.

development of the community. Hence, the decisions and choices the person makes should have more importance to the community. If the community is a capital venture or a joint-stock company, the assertions are almost entirely true.

However, what would happen if someone tried to apply this idea in political communities? Such an attempt to establish a political community and a joint-stock company concurrently was made when the first British colonies were founded in America. The charter of King Charles allowing the foundation of the Massachusetts Bay Company did not differentiate between the economic association (the company) and the social community (the colony). The King in the charter treats equally, and in the same manner bestows, the lands, mines and minerals as well as social jurisdictions: '[…] with all the firm lands, […] mines, and minerals, […] jurisdictions, royalties, privileges, […] and preeminences,'.[223] The entire social organization of the colony was at first subordinated to the corporate structure and the bodies of the company. For example, the political franchise in the colony extended only to shareholders of the company. In addition, the other bodies of the colony were actually the bodies of the company.

There also were other arrangements in the first American colonies tying the social and economic organization into one. Maryland issued paper money when the rest of the colonies did, at the end of the 1720s; but unlike the banknotes in other colonies, these from Maryland also paid their holders a dividend. Maryland declared a 30-shilling dividend to each taxpaying citizen, before the paper money was replaced by coins, as in other colonies.[224] Though this dividend was paid only once, the experiment is worth mentioning as this was the only time (at least noted) that the general political affiliation to a social community was financially rewarded, and in this way compensating for the part of the risk of living in this community.

This model of arrangement of a social community based on the organization of an economic corporation was not to last. Simply put, the

[223] *The Charter of the Colony of Massachusetts Bay*, 1628, in *Charters and General Laws of Colony and Province of Massachusetts Bay*, 1814, T. B. Wait & Co, Boston, www.google-books.com, p. 18.

[224] John Kenneth Galbraith, *Money Whence It Came, Where It Went*, 1976, Bantam Books, Toronto, New York, London, p. 65

logic of capital did not necessarily overlap with the logic of people, just as the interests of capital do not entirely overlap with the interests of the social communities as a whole. Public interests are too varied and copious to be reduced to shaping and managing the business policy of a corporation, even if all the members in a society work on it. The interests of a corporation are narrower than the interests of a community, although they do form a part of it.

Additionally, it does not necessarily mean that the one with the greatest stake in a company is at the same time the one most responsible for its operation and development. As illustrated in the quotations from the previous chapter, Christopher Lasch spotted an entire special stratum of society, whose members based their livelihood on capital management, although they were far from holding the majority ownership in their joint-stock companies.

There is one safeguard against the violation of the principle, and that is the principle of transparency of positions, which enables any interested person to become informed about a company's business policy. Disagreement with the way business policy is run breaks the link among individuals – the members of a joint-stock company – through the awareness of the mutual goal.

When the goal no longer motivates individuals to join an association, they cease to feel a responsibility for its operation and development. The do not want to continue sharing the risk of achieving a changed goal, and they strive to leave it. When it comes to joint-stock companies, leaving means selling shares. Therefore, the economic and political systems require stock exchanges and a developed financial market. The mechanism of stock exchange trading enables members to relinquish their association with a joint-stock company. Without a stock exchange, organized in detail and developed, there could be no shareholding in its full sense.

Through the stock exchange, and by the sale of shares, the responsibility and risk connected with the issuer are removed. The more it happens, the more it expresses a crisis of confidence in management; and, at the end, it could lead to a takeover of the management of the company by the purchase of plunging shares in order to redefine its activity.

The goal set anew might lead to a boost in confidence and a wish to participate in achieving the new aims. There will be those who want to take the risk and responsibility for achievement of the goal by purchasing the company shares on the stock exchange. That is how the principle of responsibility and risk is refreshed.

III.2.6. Electability and replaceability

Application of the previous principles logically leads to two additional principles: electability, which is the potential for the highest possible number of individuals in a community to become members of the body governing the community; and replaceability, which is the prospect to easily and quickly replace a holder of any public position, especially an executive one, in cases of crisis of confidence expressed by the community.

All the previous principles – anonymity on the level of individuals and transparency on the level of positions, freedom of association in order to achieve a mutual goal, striving towards a quality mass-society character, division of responsibilities and risk – are integrated in the principle of electability and replaceability, without which implementation of the other principles would be exposed to constant threat and disturbances.

Both political and economic communities have moved a long way toward the acceptance of this principle. For both, the journey began from the closed, exclusive communities in which decision-making was a privilege granted to a narrow circle of persons.

More or less concurrently with the political process of expanding decision-making to wider circles, another process occurred, based on the logic of capital, forcing joint-stock companies to issue new shares and to sell them to a wider and wider public.

Privileges are difficult to renounce. In the same way, the widening of the circle of shareholders did not mean the principle of electability could be immediately applied to them too, as the principle of replaceability could not be applied to directors of joint-stock companies. Replaceability was acceptable only in a narrow circle of majority owners, which was made possible by both confining and increasing electability. This was followed by restrictions in publicity of positions, so the information remained in the circle of the privileged. Obviously, the principles mentioned here, and their application, should be considered cumulatively. Limitations imposed on one of the principles inevitably bring restrictions on all the others. In this case, the other principles were 'attacked" too, starting with the mass-society character and freedom of association.

The breakthrough which brought about full application of the principles occurred at the beginning of the 1930s, fostered by the Great Depression in the United States. It was marked by adoption of the Glass-Steagall Act, the establishment of the Securities and Exchange Commission and the development of publicly responsible stock exchanges. Owing to the changes, operation of joint-stock companies became more open, and the work of the management and rights of small shareholders received special protection.

Thus protected, on the basis of readily available information about business policies, individuals began to opt more and more for investing in securities as the crisis subsided. Their role on the financial market became increasingly significant and joint-stock companies had to turn to their interests in organizing the companies. The stock exchange, on the other hand, provided an additional impetus as a form of the special mechanism for voting on confidence.

Finally, following the stream of development, we come to the moment when replaceability is technically not difficult to be carried out, and electability limited to one condition only – the size of the block of shares necessary to secure sufficient influence at general shareholder meetings. Owing to the mass character of shareholding, the size of this block of shares is represented by very small percentages of the total equity, on most developed markets.

In addition, the stock exchange is an institution which not only gives wings to shareholding as a form of economic democracy, but also imparts to this economic democracy a trait whose lack made all the other attempts to organize it to fail. This is profitability. Any 'voting' that takes place on the stock exchange, i.e. any purchase and sale of shares, offers the opportunity for profit. From the viewpoint of the entire system, as well, the stock exchange and shareholding represent the most economical way to organize and implement democracy in economy.

CORPORATE GOVERNANCE

III.3.1. Democracy within a company

The principles of economic democracy set forth in the previous chapter became connected with open joint stock companies. Dispersion of ownership in the companies makes it necessary to adopt and align certain principles on the basis of which those competing interests have to be regulated. In the same manner, it is essential to have the harmonization of different interests in a political society regulated through the system of certain institutions and procedures. Otherwise, there would be looming disintegration of the joint stock companies and collapse of the political society.

However, interests of shareholders are not the only governing factor in the behavior of a joint stock company, and they are not the only ones that are fulfilled through it. Likewise, the interests of politically-active citizens of a social community are not the only ones who determine events in it. On the level of open joint-stock companies, there are several more stakeholders in addition to shareowners. Harmonization of these varied interests – which sometimes run in the same direction and sometimes are directly opposed – is regulated through a system termed 'corporate governance,' which in a specific way represents the further, deeper development of economic democracy.

Corporate governance is an English-language term, and it fails to even closely reflect the complexity of the mechanism it denotes, not even in the form of an association. In order to grasp the essence of the concept, to understand what is meant by corporate governance in its full sense, we must digress for the moment and step away from what the term immediately implies. Corporate governance is much more than merely governing a corporation and it would be erroneous to apply only such superficial reasoning to it.

The starting point has to be the fact that companies are formed to make profit by carrying out their core activities. However, companies cannot be reduced to only an instrument of the outlined monosemic and unidirectional interest. Companies are not the most basic, starting units of an activity. They denote the most fundamental group of interests arranged together around an activity.

This is especially true for open joint stock companies, those whose shares are traded on regulated markets. The notion of corporate governance is connected with them before all the others, and for our purposes, the terms company, corporation and firm shall all denote an open joint stock company.

The Principles of Corporate Governance as formulated by the OECD and adopted by the Global Corporate Governance Network of the World Bank can be applied to other forms of organization of capital. Furthermore, these forms will also feel the beneficial effects of the application of the principles, the same as open joint stock companies. The explanations of how companies work – which take into account that companies are sets of several groups of stakeholders in which any of the groups has prioritized its own interests – might be found relatively early in economic thought, presented in general outlines even with the economic classic theoreticians. Considering the full meaning of the notion, the definition was developed not earlier than 1992 by the British, in Cadbury's Committee in the Cadbury Report, and in 1994 by the American Law Institute.[225]

The OECD rightly realized the importance of corporate governance, and it developed a comprehensive definition of corporate governance in 2004.

'The internal means by which corporations are operated and controlled […], which involve a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and shareholders, and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.'[226]

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[225] Mirko Vasiljević, *Korporativno upravljanje – pravni aspekti* (*Corporate Governance - Legal Aspects)*, 2007, Faculty of Law, Belgrade University, p. 22.

[226] *Corporate Governance Manual*, IFC, 2007, Belgrade, p. 6.

The OECD also explained in what ways good corporate governance is achievable and what its goal should be. In accordance with such a detailed language of the definition, the role of OECD was very active. At the beginning of the 2000s, it organized a series of roundtable discussions in different regions of the world. This lasted several years and resulted in the formulation of white papers which recommended for different regions the best way they could apply the principles of corporate governance. One such white paper was created for SEE countries.

The International Organization of Securities Commissions already has initiated a set of activities for mandatory application of fundamental principles of corporate governance in companies other than open joint-stock companies, all under the auspices of national capital market regulators. Additionally, since the Istanbul Conference in 2002, IOSCO,[227] although called international, has gradually started to assume features of a supra-national regulator whose principles are to be applied on national markets, almost compulsorily.

III.3.2. A company as a set of interests

Thus, companies denote sets of certain interests created on the basis of relations established in the course of their formation and operation. Interests do not exist in a vacuum, and they cannot be expressed by themselves. They are created as an aspiration to fulfill some needs and requests. Those for whom these needs and requests are their own gravitate toward the interests for their fulfillment.

Further, a step in understanding the notion of corporate governance is a step toward defining different interests in a company. Among all the different interests, the agency problem is the first that was theoretically described. It occurred because of the separation of ownership of capital and its management.

There is documentary evidence that the agency problem and other relations created because of different interests within a company may be traced back to remote past. It arose whenever the separation of interests in entrepreneurial ventures became sufficiently recognizable to demand

[227] International Organization of Securities Commissions

separate, special legal norms in order to regulate interest of all stakeholders in such a venture. There are early examples in our region in the medieval Articles of Kotor Maritime Partners of St. Nicholas the Mariner (*Statut kotorske bratovštine pomoraca Sv.Nikole mornara*) from 1463. It contains clear norms for steering a ship and for commercial ventures which allowed to the ship owner exclusively,[228] or to the captain. The role of those who participate in the commercial venture is limited to that of an investor,[229] and they must remain separate from management. The Dubrovnik Articles (1272), on the other hand, does not infringe the right. On the contrary, it formalizes in detail the relations between ship owners, investors and mariners, creating triple associations[230] for each venture respectively, precisely regulating mutual relations.[231]

Although the separation occurred as early as the formation of the first joint-stock companies which might be called modern against current standards – at the time of the Dutch East India Company – it became a widespread phenomenon only when the shareholding became widely present, primarily in the United States two centuries later. Vesna Aleksić offers this explanation.

'As the corporations grew wider and wider, there was a tendency to fragment the ownership right to a large number of shareholders, none of which held a sufficiently large number of shares to manage the corporation on their own. Thus the right of ownership and management started to separate from each other. Although in the eyes of the law the corporation remained in the hands of shareholders, often did they have no control whatsoever over its policies. Now the ownership right meant only the right to a dividend in the amounts the management decided to allot. The function of representation of interests, including the right to control and appoint managers was performed by investment banks then.'[232]

According to Prof. Mirko Vasiljević, the Dean of the Faculty of Law of the Belgrade University, the agency problem presents itself in three ways:

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[228] patruni

[229] parcenevoli

[230] entega

[231] Blagojević Mirjana, doctoral thesis *Articles of Kotor in light of the Dubrovnik and Budva Articles*, not published, for more details: *Articles of the St Nicholas Guild in Kotor dated 1463*, with changes to 1807, Kotor, 2009, *The Articles of the Town of Dubrovnik from 1272*, Dubrovnik, 1990.

[232] Aleksić, p. 41–42

- ❖ Its first manifestation, which Adam Smith observed, occurs with the relation between shareholders (company owners) and the management. The biggest danger here lurks from the lack of interest of shareholders (which we have written about in the previous chapters on democracy and the principles of democracy) and the unreasonable expenses the management imposes on the shareholders;
- ❖ The second manifestation of the agency problem occurs with the relation of majority and minority shareholders; the former and the latter might abuse their position;
- ❖ The third manifestation of the agency problem is connected with a controversy surrounding the capital which joint stock companies should surpass and concerns the potential conflict of individual interests of shareholders and the synergetic interest of a company as a whole.[233]

Profit is primary interest of any company's owners. It has motivated the owners to join together in a corporation. Compensation is the next corporate interest. Employees work in a corporation expecting good and regular pay, and those who govern a company – the managers – share a similar interest.

In its operation, a company enters into various relations in the marketplace. This introduces new interests into its operation. The simplest are those created on the basis of debtor-creditor relations, for example with banks, but also with suppliers and customers.

Companies also have various relations with their surrounding environment even outside of the market. This introduces one more class of interest into our study, leading to the state and society. The state is an active factor in each economic environment. It determines business frameworks, by regulating all the phases of a corporation – its incorporation, operation, tax collection and dissolution. The state in transition countries has not built its real role to this end, and it also may be seen as a partial or full owner of banks and companies.

Finally, none of the companies are created or operate in a social vacuum. Their immediate surrounding is credited with their results (both bad and good) at least as much as the management (both successful and

[233] Vasiljević, p. 20–22

poor). The mentality of workers, or work of local self-government (municipal) bodies and local community are all vivid examples of this; and the firm is bound closely to the community's interest in the creation of employment. By actively building relations with the environment, the firm directly invests in enhancement of conditions for its own operation. At the same time, it needs to admit to the local community that it too, considers their interests for the good of its business.

III.3.3. Stakeholders

The basic stakeholders related to a company are shareholders (owners), management (managers/directors), employees, business partners and creditors, and the state and local community. However, by naming them we have not reached the fundamental, individual interests, those supposed to be monosemic and directed towards meeting only the basic needs and requirements.

III.3.3.a Shareholders

Each shareholder faces a dilemma: whether to content oneself with fulfillment of a short-term interest and vote for payment of the entire profits at the general meeting of shareholders; or to vote for the partial or complete reinvesting, thereby shifting the prospective (increased) profits to the future. The assumption is that this dilemma is easy to solve when it comes to shareholders, since by the act of joining the joint stock company a partial response was already given; the shareholder opted for a more lasting alternative. Retaining a profit in a company results in an increase in stock prices, and the unpaid dividends might be compensated for by the increased value of the shares.[234]

[234] More about this in the chapter on shareholding.

III.3.3.b Management

The dilemma managers are facing is less visible. The management receives remuneration for their work; therefore, their interest should be summarized in efforts to agree on the highest possible amount of the remuneration upon entering a company. However, while implementing a business policy, a company's management is in a position to use the situation to their benefit in other ways too, getting a profit of its own kind from the position occupied.

The problem lies in the fact that these compensations are often taken from the company's capital, and they commonly assume different forms of asset stripping. The fact that this endangers the company's operation and survival generally is not motive enough for the management to give up the practice; on the contrary, it induces them to make maximum profits, disregarding the company's future.[235]

What largely mitigates the problem is introduction of managers into the company ownership structure, although it does not resolve the issue in its entirety. The process whereby managers become owners can assume different forms, but the most prevailing are stock options assigned to managers for future purchases of shares.

The principle of democracy which we have connected to the publicity on the level of institutions also largely restricts the negative practice of asset striping. The publicity of work and daily trading of shares of joint-stock companies have proved to be the best instruments in disciplining managements. Ron Chernow believes that in this manner they 'equalized the status of company insiders and small investors on the outside.'[236]

Moreover, he praises the 'American model of a stock market-based economy'[237] because

'… the principle was irreversibly established that companies were

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[235] There has been in our practice (Securities Commission of Republic of Serbia) an example of a successful company where the managers tried to turn the entire two-year profit into shares, and then to distribute the shares as a managerial bonus to themselves!

[236] Chernow, p. 43

[237] ibid., p. 65

answerable to shareholders and had to meet universal performance requirements [...] Every CEO in America must now ponder the stock price of his company as a daily verdict on his performance and a possible prophecy of the length of his tenure.' [238]

Chernow also contends that the operations and the life of the privileged class of capital managers is not quite as described by Christopher Lasch.[239] Chernow says that the principle of publicity is reflected in their everyday work, and he explains the reasons why the principle, together with the other principles of democracy (where fully developed and applied), almost made it impossible to jeopardize the interests of shareholders by the management.

'Fund managers inhabit a fishbowl world where everything is quantified, objectified, and published; [...] If they fall behind in the race, they are quickly cashiered, for apart their ability to deliver superior performance, they have no independent source of power [...] Investors care about rates of return, not personalities [...] who follow their stocks and mutual funds and transfer money, in an instant, from places of lower to higher returns.'[240]

III.3.3.c Employees

The dilemma faced by the other employees is very similar the management's. Employees consider their salaries, preferentially as high as possible, to be the most important. However, no demand of a labor union should come before the continuation of a company's operation. When a company ceases to operate, there are no more jobs.

Here in Serbia, where transition is taking place, things are further complicated. Owing to the chosen privatization model, many Serbian employees have taken on the role of a shareholder. Developed markets make a clear distinction between employees and shareholders,[241] the

[238] Ibid., p. 66

[239] Lasch, p. 34–37

[240] Chernow, p. 79.

[241] Though there are many examples of companies in developed markets – especially tech companies – in which a large number of employees are shareholders

distinction stemming from their clearly-defined positions. At the same time, shareholders and investors are synonymous terms on developed markets, since one becomes a shareholder by making an investment through the purchase of shares.

In contrast, Serbia still differentiates between shareholders and investors, because a considerable number of shareholders received their shares for free. Often they are called reluctant shareholders. Their interests differ from the interest of those who became shareowners by means of purchase and are mostly reduced to hastened and hurried sale, even at a reduced price, with a sole aim of having the cash in hand.

Such a behavior of shareholders in Serbia changed by the distribution of free shares of Naftna Industrija Srbije (Oil Company) and Aerodrom Beograd (Airport Company Belgrade). Although they have received the shares for free, the majority of shareholders did not sell them but started to behave as investors. The change in the shareholding mentality might be attributed to the fact that this is the eleventh year of transition in Serbia. In the course of the transition, much could be learned about shareholding and the capital market, either through organized educational campaigns or in the wake of shady affairs that broke after the sales or purchases of some companies' stocks and raised the awareness on what shares are.

Paradoxically for the Serbian reluctant shareholders, the dilemma of the employees is mitigated, similar to the managerial dilemma, by their introduction into the ownership structure of the company in various ways.

III.3.3.d Creditors and business partners

Creditors deserve a special emphasis as business partners. The interest they have in perpetual continuance of the company and executing its core activity should not be questioned. If a company falls into arrears with payment of its liabilities, then these stakeholders are in a dilemma whether to collect the receivables to the highest extent possible, or to engage in restructuring payments and prolonging collection of the accrued liabilities in order to have the debt cleared at a future moment.

Other business partners, suppliers and customers should not hold a different interest than the one connected with perpetual functioning of a company. Only if a company turns delinquent, are they put in the same dilemma as that of the creditors. In such situations they too become creditors.

III.3.3.e The state

The most complex and even the most contradictory position is that of a state functioning as a co-owner in a company. Without going into details of justifiability or the logic behind the position of a state as a part owner of a firm's equity, we can only say that this was a legacy left to Serbia and many other countries, especially those in transition. Some of the countries addressed the situation by identifying quick remedies to the situation, and some dealt (and some are still dealing with it) by gradual implementation of privatization.

States exist for the purpose of public interest, to mould it and implement it. Contrary to that, corporations emerge from private interest followed by its cultivation, development and maximum utilization. These two kinds of interests are difficult to reconcile. Representatives of the state serving on a company's board of directors cannot subordinate the private interest to the public. Once more, by taking care of the public interest frequently, the private interests of other shareholders will be endangered.

For example, it may be in the interest of the state, not to allow investors from certain countries or to bar certain types of investors from becoming majority owners of some companies. However, the other shareholders are interested only in the price of their shares. Dilemmas like these cannot be addressed by merely gaining a majority of votes in meetings of boards of directors or general meetings of shareholders. If the state representatives remain in the minority, the state easily will become tempted to react by inertia, utilizing all the available instruments of its institutions, including the instruments belonging to *ius imperii*.

Hayek described, although in general features, the tendency to such a behavior by the representatives of the state (and who introduced themselves as the state), encroaching too readily upon the instruments of legal remedies not suitable to the business environment. Nevertheless, his conclusions might be applied to the position of the state itself as a shareholder; Hayek, speaking about governmental economic strategy, discussed what it meant and how the mentality of state was manifested.

'As soon as the state takes upon itself the task of planning the whole economic life, the problem of the due station of the different individuals and groups must indeed inevitably become the central political problem. As the coercive power of the state will alone decide who is to have what, the only power worth having will be a share in the exercise of this directing power. There will be no economic or social questions that would not be political questions in the sense that their solution will depend exclusively on who wields the coercive power, on whose are the views that will prevail on all occasions.'[242]

The Serbian practice has proven this more than once. No matter how important *raison d'etat* is to those who represent a state for a certain period of time, and even more important than the private interests of other owners, this state of being is highly detrimental to stability of the entire business processes of a market. Corporations cannot function on the basis of the public interest. The only way to leave such a situation behind is to complete the privatization processes and ban the state from gaining proprietary rights in companies.

III.3.3.f Local community (society)

The relation of companies and local communities is covered by a special set of relations termed 'corporate social responsibility" (CSR), side by side with the notion of corporate governance. The interest of local communities is the least questionable and the simplest. It is reduced to the longest possible functioning of a company in its environment, without endangering the values of the environment and, indeed, by developing and advancing those community values.

The term 'local community' should be taken conditionally. Companies can overcome the confines of the local communities from which they originate by performing their core activities. The larger the company, the larger the community with which it is associated.

[242] Hayek, p. 119

III.3.4. Reconciliation of interests

Companies have various inherent interests grouped on the basis of the functions of all the stakeholders for their core activities. Not only are the companies not bearers of single interests, but the interest groups within them do not have the same or single interests at any given moment.

So many confronted interests easily could block the functioning of a corporation. However, disregarding them would not lead to anything. The interests are legitimate, and ignoring them will not nullify them. On the contrary, the ignored interests accumulate, and instead of their gradual fulfillment, they require prompt satisfaction of interests at a moment, inflicting harm to the recognized interests. Instead of a state of balance and the synchronous satisfaction of the interests of different groups, we have alternate gratification of some groups, which overpower each other and upset the balance of the entire system.

As is the case in any other organization, the only solution is to foster institutions and processes which facilitate the molding of interests, attaining synergy with other interests and aligned gratification of interests with the continuance and work of a corporation. We already have identified the stakeholders in a corporation. We also have recognized the interests leading them in their conduct, and the effect on the company's operation.

In order to have a more organized overview of the plethora of interests, they roughly can be divided into short-term and long-term. The former start from immediate gratification, maximizing the profits as quickly as possible, regardless of the future destiny of the company. The latter, on the other hand, start from the notion that the highest profits of a company's operation are generated by the longest, uninterrupted operation of the company and constant improvement of its business performance.

The different traits of these interests, and the potential for their confrontation, are depicted by the following table.

Stakeholders		Interests	
		Short-term	Long-term
Shareholders (investors)		– +	+
Management		+	– +
Employees	Workers	+	– +
	Shareholders	+	–
Partners	Creditors	– +	+
	Suppliers/customers	– +	+
State		+	–
Local (and wider social) community		–	+

Situations marked with a plus in the table indicate an unequivocal interest that motivates activities of the group members. The opposite is marked by a minus, signifying a complete absence of interests and, therefore, motives for action in the area. Plus and minus signs put together in the grey fields signify that members of the interest group might recognize the existence of the interest in some situations and might not in others.

III.3.4.a Long-term interests

A clearly expressed long-term interest for survival and development of a company is identifiable with shareholders (co-owners), business partners and local (and wider) community. In special cases, for example when there is a crisis, the long-term interest of shareholders and their business partners might be replaced by a short-term interest, a general market interest or the business interest linked to the company's core activity.

Here, the interests of shareholders and business partners become mutually opposing in the short-term. The regulations governing corporate governance and the institutions implementing them should give priority to the gratification of partners' – that is, creditors' – interests.

III.3.4.b Short-term interests

Management and employees of a company have clear and unambiguous short-term interests. Hence the ever-present latent conflict between owners and shareholders, regardless of whether they are management or appointees and workers.

Employees who have become shareholders in the course of privatization – the so called 'reluctant shareholders' – have no other interests than the short-term. Their connection to the shares is ended in the most cases by the first offer of a buyer. Sometimes these shareholders take a step further and form associations, but the activities of the associations often are reduced merely to getting the best possible price, or to sell as many shares as possible at once, in order to get the take-over premium. It is very rare for these associations to engage in anything different, for example, the protection of shareholders' rights. The Serbian practice has given birth to an unusual affiliation of trade unionism and shareholding. Some of the trade unions have initiated aggregating employees/shareholders and gradually evolved from union organizations into shareholder associations.

However, management and employees are of great importance for the functioning of a company. Therefore, it is necessary to encourage them to recognize their own long-term interests in holding to ownership, especially bearing in mind it diminishes the original conflict of owners and employees.

The principles of corporate governance stipulate participation in the decision-making processes for appointees and workers, with the right to discuss issues in the company's bodies, most often without a granted right to decide.

When it comes to the management, additional measures are necessary, which also is envisaged by the principles of corporate governance. In addition to the additional ways for becoming an owner, it is necessary to oversee the management in more ways.

Publicity of work and availability of information to all interested parties represent a *conditio sine qua non* of their activities. It is necessary to clearly sanction any absence of such behavior.

III.3.4.c Public interest

The state interest should be engaged in provision of favorable business conditions as well as in collection of taxes. We have already stated that states undergoing transition have a specific role, which directly brings them to the area of regulating corporate governance as (co)owners of banks and companies.

Admittedly, the specific position and the role of a state are not only true for transition conditions. Developed markets, even those serving as paragon of liberalism, also have seen their states directly involved in business operations of some of the companies. It is, of course, disputable whether the state becomes involved, or its representatives. This could lead further on to considering a state as a defender of public interest, and whether public interest as such even exists.

It could be easily proven that what we call public interest is instead an interest introduced into institutions by certain groups which have won the elections (or used other political and non-political means) to rule these institutions. The interest of these groups represents, in the end, the interest of individuals joining in gratification of their personal interests.

Without going deeper into such considerations, we can only conclude that public interest has no place in a company created on the basis of private interests and developed for the purpose of the private interest. All the more, the state and its representatives have only short-term interest in a corporation, equaling the interests of reluctant shareholders, and should sell the shares the sooner the better. Until then, unfortunately, the regulations governing corporate governance are not sufficient to prevent conflicts between representatives of public interest and the other stakeholders in a company.

Completion of privatization and termination of the state's participation in ownership nullifies its direct interest and consequently removes the danger of supremacy of the lack of a fundamental motive in the decision-making process and in improving a company's business. The interest of the state is then reduced to a communal, long-term interest that the company should continue its unhindered operation and advance its activities by job creation and paying more taxes.

III.3.5. Definition

The table clearly indicates the areas requiring special attention regarding regulation of relations among different interest groups within a company. These are the fields marked by a plus and a minus at the same time (the grey fields). These are the areas where a conflict of interest of different groups is possible, since some of them opt for short-term interests and some prefer the long-term interest.

If the conflicts of interest are not addressed in continuity and in a balanced manner, by considering all the interest groups present, it might lead to disturbance in the functioning of a company, and even to its dissolution. Here lies the special significance of the manner in which these interests are addressed within a company.

A company's activity should be directed toward gratification of long-term interests, those that ensure the continuance and further advancement of a company's activity. When taken in this context, corporate governance gets its full meaning as a notion. In this way, we have reached its essence – a manner of regulating the interests of different groups within a (open joint stock) company.

This brings us back to the OECD definition of corporate governance quoted at the beginning of this chapter, which encompasses the term corporate governance in essence, but also refers to bodies of companies, its institutions. Through the institutions, the essence of good corporate governance can be achieved in certain ways. As is the case with democracy as a higher notion, the resolution of interests yields results that suit all the stakeholders only if they are gratified in ways precisely determined through developed procedures within the institutions which manage and implement the procedures.

III.3.6. Institutions of companies and society

Regulated communities, whether social or economic, political communities and open joint stock companies must ensure that the interests of various groups pursue are satisfied. The satisfaction should be balanced, providing each interest group the prospects and possibilities to achieve their goals fully, if possible. Concurrently, any threats to the satisfaction of other groups' interests have to be avoided as much as possible.

In political communities, this is achieved by a system of institutions that we recognize as the state. Work in institutions and activities on pursuing interests have to be regulated, i.e. determined by a series of procedures. The procedures protect interests of a group against the others, by making a balance and by finding resultant effects thereof.

As some institutions are essential for the state – the parliament, political parties, courts – thus open joint stock companies form special institutions for the purpose of satisfying interests. The fundamental institution is that which protects the oldest of all interests, as a summation of companies' developing interest that founded on ownership. The starting point of all further developments and guidance in management of a joint stock company has to be the general meeting of shareholders. The interests formulated in decisions brought at these shareholder gatherings are fundamental and should not be neglected or dismissed.

The board of directors and supervisory boards are the next most important institutions safeguarding the contemporaneous satisfaction of all other interests. . In most of the cases, here ends the list of bodies pertaining exclusively to the company. The board is a meeting point for all the interests expressed through representatives of employees, management, creditors and business partners.

In this way, the principles of publicity/transparency of work of companies' bodies and confidentiality of action at the level of shareholders become embodied. Electability and replaceability are also the principles ensured in companies' bodies, as well as division of responsibilities and risk.

However, freedom of association and the qualified mass-society character, as principles of economic democracy, demand wider approach for their gratification than the three abovementioned principles. The institutions outside of the companies – the state institutions – should stand behind these principles. As the principles of democracy in politics are safeguarded by specialized institutions, the same is with economics; special institutions are developed for the purpose. At the end, protection of all different interests cannot be attained only by the general meeting of shareholders, board of directors and supervisory board. The conflicts which surpass the capacity of these bodies, and thus violating the principles of economic democracy, must rely on the state and its constituent institutions. The most prominent position is, of course, occupied by the capital market regulator, which bears different names in different regions: commission, agency and authority among them. Its powers are explicitly identified by relevant laws.

However, ownership disputes exceed the regulator's jurisdiction, and they must be addressed only by the courts, due to their fundamental significance for the society. The capital market regulator only can oversee the processes in which property changes hands, is registered and transferred to new owners. Oversight of the process is conducted by controlling the work of the institutions which are implementing them. For trading, they are the stock exchange and the agent network, broker-dealer companies, funds and banks. Registration recognizes a network of authorized agencies, or in countries where there is a centralized system of registration, the central securities depository.

All that does not belong to regular proceedings, prescribed procedures and the capital market institutions – because of violations of the regulations – necessarily becomes an infringement of proprietary relations. This leads to the other branch of power – judicial power. Protection of interest is concerned here with proprietary interests that stem from ownership. Infringements of borrower-lender relations are also resolved before the courts.

The executive arm of power is rarely the one that can actively improve protection of principles of economic democracy. The best role it may have in the system should be partial legislative initiative, i.e. participation in defining the total setting for activities of joint stock companies. Departure from this sphere jeopardizes realization of the principles of economic democracy, and of political democracy as well. It upsets the balance of interests at the level of open joint stock companies and of political community, and it hinders their commensurate gratification.

CONCLUSION

IV.1. Polysemy of shareholding

We have seen from what has been presented here that shareholding as a phenomenon has multiple meanings and layers. The core meaning has always been tied to economy, as the main field where it grows and develops. The methods of management in complex and interest-loaded shareholding companies have been tied to it as well, but only recently. Therefore, it is tied to corporate governance. However, any further consideration and attempts at explaining and deliberation of the shareholding phenomenon would immediately take us to other areas of the social, from the rights to the impact on formation and preservation of social structures and forms of organization of society as a whole.

At the very beginning, if the beginnings of studying shareholding are linked to the economic sphere, economy itself has to be viewed in a wider context. It must be seen not only as an area within society or a set of activities performed in a society, but as an integral and inseparable form of the social system as a whole, in a series of interrelated reactions and relations. Therefore, for shareholding to be viewed and explained, and finally, its development followed in its entirety and importance, it is necessary to study it against the full backdrop of social relations.

That is why economy and other form of social actions need to be viewed through the lens of their interrelatedness. Attempts at explaining a phenomenon in a complex and layered way, without taking one's position to the environment where it appears, exists and develops would pose a methodological error. Economy itself has gone a long way and developed for a long time and without previously having seen its social character and its effects on the society and the responsive influence of the social to economy.

This train of economic thought has been expounded in the first part of this paper. It should be emphasized here, once more, that shareholding in essence could not be studied by ignoring the social aspect of economy. This would deprive us from the possibility to see the social aspect of shareholding and, thus, the main reasons for its appearance. Moreover, nowadays shareholding is a phenomenon establishing the strongest links between the economic activities and the social surrounding where they develop. Its development is tied to a clearly-set type of social relations, which in turn demand a specific manner of organization of economic activities. Shareholding in its development assists and supports, concurrently and equally, such social and economic relations.

The fact that shareholding appears in its full form in market economies, which cannot develop without an open, civic, democratically-organized society, is not accidental. On the contrary, it has deep cause-and-effect reasons. Only the liberal economy would facilitate all free capital to become part of the general economic activity, no matter how small. The pooling of capital through the emergence and development of joint stock companies facilitated such economic democracy.

IV.2. Economic and democratic

On the other hand, for this to happen, it was necessary for such economic relations to be accompanied by social relations, which not only do not have an adverse effect on them, but spur them and protect them. An array of institutions which created such an environment is recognized as the contemporary democratic state. Only in this way was the real environment created for the flourishing of shareholding.

This tied shareholding as a phenomenon to a certain social environment, too. The freedom of entrepreneurship, a vital prerequisite for its emergence and development, cannot be established in societies of authoritarian institutions. It requires an open and free society, and basic liberal principles. In a political sense, such a society is shaped into parliamentary states whose systems are called democratic.

In order to continue studying the phenomenon of shareholding, it was necessary to deal with the social environment where it develops. We have seen that such an environment is recognized and classified as democratic. Getting to know and determining the category of democracy was an inevitable step in the further study of shareholding. This is at the same time the most complex category explored in this paper.

From the beginning, democracy has been accepted axiomatically and therefore in only limited fashion, as immediately leading to insubstantiality in most of the uses of this category. It has been reduced to mere mass-character, without deeper thinking of what should be done, what its essence is and in what ways that essence will be demonstrated. The first deeper comprehension of democracy will point to its dynamic character, as opposed to the static principle of autocratic societies striving to conserve their certain social relations and positions within them.

The dynamic character as a fundamental characteristic determines yet one more category this paper has to dwell on – capital. When it comes to capital, this determinant is absolutely defining, as it is the case with democracy. If dynamic character is taken away from capital, it just ceases to exist as such. Thus the dynamic character represents a direct link connecting ideals of democratic societies with materialization of capital. Shareholding as a form of pooling capital represents the most dynamic form of its materialization.

This is where we find the solution to the seeming paradox. How is it that societies with highly developed democracies are at the same time the most affluent and economically prosperous ones, although democracy as a system of organization of a society is most definitely the most expensive one? The answer lies in the fact that the dynamic character, as one of the fundamental principles of viability, is only common with democratic societies. Therefore, the resources of a society are the most easily and most simply transformed into capital in such a dynamic environment. Any change in a social system aspiring to suppress the dynamic character and conservation of a situation must lessen the possibility of capitalization of social resources and, therefore, impoverish capital. Dictatorships can be economically prosperous only for short periods of time.

If the fundamental principle of democracy is a dynamic one, it means that certain process for its development must be provided. The processes are lost in a diffuse manner if not concentrated into certain institutions that manage them. Of course, the mere existence of institutions and their processes in a society do not make it democratic. The character of the institutions and the processes within them make a state, society and its system of organization a democracy.

A set of clear rules and principles will determine whether the character of institutions is democratic or not. They need to provide the *raison d" être* of democracy which inspired certain communities to begin establishing relations now recognized as democratic – how to provide an undefined number of individuals who do not know each other equal participation in the adoption of decisions that determine their very existence.

IV.3. Common principles

In both democracy and shareholding, direct participants in decision making do not know each other – there is no direct contact among them – and still the decisions they make affect each of them. In order to establish such an organization that will be viable and functional, the fundamental principles we have described in this paper must be followed. The recognition of the principles, their formulation and acceptance by everyone or by the decisive majority of all participants, is equally required for democratic political communities and for the functioning of joint stock companies.

Owing to the principles, shareholding links the economic with the wider social sphere. Moreover, it is only through its application and incorporation that by means of shareholding the strong link between economy, economic development and development of society towards democracy may be established. Let us underscore once more; the principles on which democracy and those on which shareholding develops are the same. These principles form the link between the economic and the social, through shareholding. The establishment and implementation of these principles in the economic and political spheres are safeguarded by means of yet another area which depicts the social relations – by law and the system of legal standards.

Certainly, any change in the environment, be it economic or social, undermines the implementation of the principles, immediately having repercussions for shareholding. Links established in such a way are easily severed, and the relations of mutual support of the development of market economy and political democracy are undermined. If the liberal, market-oriented characteristics of an economy weaken and are jeopardized, then the probability is high, even certain, that the democratic characteristics of the social environment will deteriorate as well.

For example, if countries in transition do not devote sufficient attention to the development of shareholding, this is a clear sign that the political elites for different reasons have lost the main direction they should follow to bring about the establishment of a market economy and democratic society. As we have pointed out several times, the character of certain institutions and their processes illustrate whether and to what degree a society is headed in a democratic direction.

IV.4. The significance of institutions

Shareholding is realized through multiple layers of institutions: the stock exchange; the capital market as a more general, umbrella institution; the network of intermediaries and institutions recording and protecting owners and their rights (in Serbia it is the Central Securities Depository); and the capital market regulator, an independent institution with clear authorizations. All of them have in detail in this paper, including the notion of capital.

Among other processes, shareholding in transition countries has helped create the middle class, which is the precondition for developing democracy. In addition, for democracy to be realized and sustained, it must provide equal conditions for life and prosperity to each individual society member.

Of course, equitable conditions do not mean that all will know how to utilize them. This is not the subject of democracy; democracy establishes a network of institutions, which need to be available to each and every one for their gratification of interests. A step further – the actual gratification of interests – has to be based on the stakeholders: individuals and social groups.

If some of the institutions take this role, it becomes a danger to the viability of the entire system. In the case of shareholding, the regulator of the capital market and courts are meant to safeguard the rights of each shareholder, but it is the responsibility of the shareholders to actively use them for their own their own betterment or loss.

The important of the character of institutions is best seen in a bank-centric system. Most of the small transition countries have been caught in this snare. The central monetary institution is by all means an indispensable pillar of the entire financial and economic system. It provides safety and stability, and its instruments for market processes are therefore adjusted to that fact. However, if the institutions are entrusted with a part of the capital market – or, even worse, the entire capital market – the system loses elasticity and its dynamism while stability and safety degrade into conservatism.

Instead of developing shareholding, growing the middle class and the dispersing ownership, the system as a whole begins to close and to turn into an exclusive club of a few banks and large capitalists. The features of democracy begin to disappear gradually, first from the economy and then from social institutions. Even large capital, benefiting from such a train of events at first, relatively quickly gets forced to cooperate with the political power and begins to act, not as private, but as the state capital. Instead of promoting efficiency and leading to economic development, job creation and improving competitiveness, its movement is conditioned by arbitrary decisions. It is most often pushed toward a fall in profitability, short-term consumption and the final loss of substance. This dynamic has been demonstrated many times.

IV.5. Limitations on economic and political democracy

It would be wrong to claim that the establishment of democratic and market principles would suffice for the progress of society. The reasons for restraints on democracy have been already mentioned in the chapter about democracy. A series of institutions can be formed and established in a society, clear procedures in such institutions can be set and made available to all society members, but this will not ensure that each member of the society uses them. A democratic system does not necessarily constitute a democratic society.

The system of institutions and the way the decisions are made are more complex when society is more developed democratically. The consequences resulting from these decisions are also complex and polysemic. It takes a level of dedication and active participation to master the processes which cannot be expected from every member of society. Professor Mijat Damjanović explains this clearly in his book *Demokratija epizodna misterija* (*Democracy – A Side Mystery*), emphasizing how complex decisions made in a society are. Damjanović contends that any important decision whose social dimensions are directly contingent on the importance of the institution adopting it and its expected effects, contains elements of politics, economics, law and ethics. It is the expression of political intentions, financial conditionality, the legal system, ethical principles and general, comprehensive consequences.[243]

Dedication of individuals to such a complex process is not easy. Often, it is even impossible to ensure it with all the members of a social community, as Olson and Hayek explained. An incentive and personal interest are the best motivators to social action.

In addition, this incentive is not always directly connected with an action. It is a process. Individuals have constant interest for a wide spectrum of social events and taking a stand on them; then actions in relation to those stands brings inclusion in processes which facilitate progress and betterment of the community and of each individual in it. These are economic processes which are most easily, quickly and efficiently joined through the capital market, its institutions and the process of shareholding.

The institutions of the capital market and its actions should not be deemed definitive in their current form. As is true for democratic processes, dynamism is also its characteristic. Interweaving of different interests there does not always produce the most favorable results, not economically nor in the sense of shareholding as an economic democracy. In his book, *The Great Crash, 1929*, John Galbraith examines the situation on the capital market in the United States in the days before and during the Great Depression. Even on such a deep market, it was possible for some of the large investment companies such as Goldman Sachs and individual investors such as DuPont to manipulate the market flows, providing themselves a better position than the retail shareholders.[244]

Even in the course of the current global crisis – the end of which

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243 Mijat Damjanović, *Demokratija epizodna misterija* (*Democracy – a Side Mystery*), 2011, Megatrend University and Official Gazette, Beograd, p. 38

244 Joh Kenneth Galbraith, *Veliki slom 1929*, 2010, VBZ, Zagreb, p. 51–52

cannot be discerned yet – the role of large investment companies was prominent in its outbreak and in the course of its expansion. Still, this is not an argument in favor of abandoning shareholding, wide dispersion of ownership and development of the capital market as a foundation for the development of democracy. On the contrary, it illustrates the fact we examined in our chapter on market architecture, that concentration of ownership, insufficient dispersion of ownership or an attempt at stopping it not only undermine fundamental democratic values but may easily push the economy and society into crisis.

IV.6. Decentralization as a prerequisite of democracy

Democracy is not a given state of social relations which can be won and then its advantages permanently enjoyed. Democracy cannot be created nor attained; it is a process of continual creation and attaining. It could be no other way in such a model of social relations, with its organization to serve the highest possible number of interests of the highest possible number of members of a social community. Constant activism, dynamism and changes which decisively define it develop on the variety and changeability of the interests of its participants, to whom it is intended to provide the ways of gratification.

The network of institutions with developed, clearly-defined procedures should provide channeling and management of social processes in the direction of the most probable satisfaction of interests. For participants in democratic systems and members of social communities wishing to build and develop democratic relations, it is of special importance that the network of institutions corresponds to the grouping of interests, so that they can be easily and efficiently addressed. Political parties, national assemblies and parliaments are the best examples of this.

However, members of society on this general level decide what they want primarily only during elections, most often once every four years. Interests will not wait to be gratified over such long time periods. Therefore, it is necessary that social systems, if they wish to develop in the direction of democracy, provide the option of institutional resolution of problems and situations on the level which is much closer to participants and which can ensure that it is a constant, unbroken process.[245]

Decentralization is an obvious resolution of this need. It becomes an unconditional necessity of democracy. Moreover, decentralization makes it possible to evaluate the sincerity of political elites leading a society, with the pace and level of its development demonstrating whether they really want to maintain a democratic social system. The highest number of never changing life interests aggregate at the level of local communities, and they need institutions and procedures to be served.

The interests are political, as they are *res publica*. This is the level where individual interests in the process of their gratification meet other individual interests, grouped according to the chances for their accomplishment, enter into institutions and thus obtain the character of being public. However, they are not political in the narrow sense of this determinant, which would link them to actions only through political parties, and in political, election cycles. It is noteworthy that the majority of interests of members of a society need to serve continuously pressure their holders for gratification.

IV.6.1. Bonds as a means of grouping interests

The greatest numbers of interests are rooted in economic activities, with or without a positive outcome. The social component of organization cannot most often meet the need of serving such interests, nor should it. However, what must be done is to find ways to gratify them, and then let those who recognize themselves in those interests to freely use the means of their gratification.

Generally, the link between the social and economic provides for the expansion of shareholding. It enables participation in business ventures of the most significant and largest companies to the widest circle of interested investors, who at the same time are members of the

[245] For more details about the relations of institutions, and the institutions and society and their social processes, please see: Dušan Pavlović, *Spisi iz političke ekonomije*, 2010, Čigoja štampa i FPN, Belgrade, especially p. 80-95.

social community. It affects the social aspects of investors' lives, enabling them active participation in economic processes – both risk division and profit allocation. It impels them to constant reconsideration of interests and constant regrouping based on it.

What shareholding does on that level, government bonds do with the same effect. Shareholding groups interests around individual, private and business objectives, while bonds group interests around public activities, introducing them into the sphere of the economic and giving them profitability. The state has to consider the public interest, no matter how we see it e. Its positive resolution should equally be of use to the members of a social community.

However, there are certain public interests around which additional interests can be grouped, but it is possible to get only few of the members of a social community involved and interested in their accomplishment. A bond represents formalization of such relations. Buying it, investors consent to sharing with the state the risk of pursuing the economic policy or the risk of a business. The principle of equality maintains that the persons less averse to the risk should get a part of the reward, provided the business is successfully led and finalized. This risk-related compensation comes in addition to the general public good that belongs to such persons and all the other members of the social community. Thus, the reward is formalized in the form of an annuity and interest.

In this way, shareholding and bonds stimulate the development of capital market institutions and protection of its investors. .Such positive effects reverberate through the entire economy and society. A widely distributed issue of bonds will have an immediate effect on the increase in the publicity of work of government institutions, especially in the segment concerning the implementation of the economic policy.

IV.6.2. Positive effects of bonds

The government which pools the money, funding the functions of the state in this way, does two strategically useful things at the same time:

1) It commits to disclose economic policy to the judgment and the eye of the widest, potentially-interested public, as the public will react by purchasing or selling bonds according to whether it trusts the government economic policy. The effect of exposure to the judgment of the public is extended not only to the government issuing the bonds, but to all future governments until the bonds mature. It can be asserted rightfully that all governments are permanently exposed to public consideration of their economic policy as the number of issued bonds and their maturity impose obligations on future governments, even if disregarding the perpetual bonds.
2) The other positive effect of the issue of government bonds is that they are almost always intended for the widest public. They are of low nominal values, easily negotiable on the widest market, attracting the wide public to the financial market. As the interest is the optimum teacher, the chances are great that holders of the options once attracted by disbursed annuities will remain on the market as investors.

Such was the role of the bonds disbursed as compensation for the World War I damages to families in Serbia. As the war forcefully swooped down on Serbia, virtually every family in Serbia had the bonds in their possession, giving them high liquidity on the Belgrade Stock Exchange. They were considered to be blue chip securities, and that is why the management of the Belgrade Stock Exchange accepted them as collateral for the forward transactions with other securities or a commodity.[246]

[246] Milko Štimac, *Srpsko berzansko poslovanje*, (*History of Serbian Stock Exchange Trading*) 1997, Stubovi kulture, Beograd, pp.183-189

There is a similar example in the United States of America, of course, larger in the scale, where the government bonds had the key role in education of population concerning the capital market. The government financed the participation of the United States of America in the Second World War by issuing bonds, reaching values expressed in billions of dollars in all issues, and more importantly, they bought by the wide population. This made the entire USA population closer to the dynamic and much more democratic way of running businesses and finances – to the capital market.[247]

In this way, bonds attracted wide investment public through the institutions of the capital market, providing knowledge of securities to the public, all that should be known and also forming the interest in the government economic policy with the public, via securities. This period can be rightfully considered to be a turning point in the development of the American market. And further development of democracy, could be added likewise.

IV.6.3. Overcoming contradictions of capital

It is often heard that democracy is an expensive system of running public affairs, but this assertion is superficial. The values that nurturing institutions and public procedures bring and the longer they are applied, the more they make society richer in terms of wealth and in any other sense. Any other system might appear more efficient in the short run, but that is dangerous and seductive. Not only that, in societies other than democratic, the basic human values become undermined in the end as they sink into economic non-effectiveness and general decay.

Still, it remains true that institutions require some funds for their functioning. The more developed a democracy, the more decentralized it should be, and thus have a larger number of independent institutions at the national and local levels of government. Such institutions should facilitate progress for all members of society that the institutions cover with their activities.

[247] Ron Chernow, *The Death of the Banker*, 1997, Vintage Books, New York, pp. 40-41

Progress will be contingent on the economic activities of the community members, which should be made more straightforward and efficient from the standpoint of risk reduction. Some theorists see the state as an association for the reduction of risk.[248] Considering the nature of any activity, especially economic, and the inherent uncertainty of final outcomes, it is easy to agree with this stand.

All the more, it seems necessary to finance the highest number of public affairs possible at the local level, where the highest number of interests of members of a community are served. The centralization of financing, through centralization of revenues and the total political and economic system is not supportive of democratic development. It drags the system towards undemocratic solutions and excludes the largest part of the community members not only from the daily political process, but also from the possibility to provide for their own progress and that of their families. There is no substitute for this, as there is no government to outperform the people themselves.

The financing of public affairs on the local level thus becomes one of the key elements for the implementation and development of democracy, not only within the local governments but also of democracy in general. On the other hand, revenues – no matter how decentralized – cannot contend with some of the basic contradictions related to economic activities based on the capital relation. One of them is that each activity requires investments in the present, while its effects are expected in the future. This is especially true for complex projects, as usually are those which should be financed by local governments and which are not always directly cost-effective.

The discrepancy between the present and the future is covered by loans. At the end of eighteenth century, under the rule of Austrians, the Belgrade municipality took loans from the Metropolitanate, with ten percent interest per annum.[249] It is noteworthy, that this was a prosperous local government, institutionally composed of guilds and their members; yet, not even such a town could finance all of its necessary activities. Formalization of the relations, set up in this way as a

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[248] Anthony Giddens, *Runaway World*, according to the Serbian edition *Odbegli svet*, 2005, Stubovi kulture, Beograd, p. 25.

[249] Marija Ilić-Agapova, *Ilustrovana istorija Beograda*, (*The Illustrated History of Belgrade*)1933, issued by the City of Belgrade Library, p.136

debtor-creditor relation, safeguards both the creditors and the debtors. It institutionalizes their relationship, be it a tally, book of credits or a modern computer system.

IV.6.4. Dispersion as protection against pressures

The advantage of institutionalization of such relations is that debt or a receivable can be more easily transferred; that is, it can be traded. At the end of the first half of the nineteenth century, the small town of Belgrade paid a man to sit in front of the Reading Club (*Čitalište*, in the today's Knez Mihailova Street) and guard the book where the passing merchants entered the names of debtors and creditors and the respective sums.[250]

Bonds represent the highest degree of institutionalization of the debtor-creditor relation, making of it a procedure to the degree that it becomes completely formal. Specific persons, natural and legal, are present at the beginning of a transaction when the bond is issued and when it is subscribed to and sold; and they also are present only when it matures for payment, partially or fully with the entire amount at the end. In the meanwhile, it is an object of trading on the capital market and practically it has a life of its own.

This is even truer for municipal bonds, as they can be purchased for small amounts; therefore, their dispersion is very wide. The benefits they impart to the local government compared to personal loans, where there is the constant personal relation between the lender and the borrower, are found in the very formality attained by the dispersion. Such dispersion does not allow misuses of the debtor-creditor relation with the purpose of championing political goals. The political processes in local governments get freed from pressures there, and at the same time its institutions are able to finance projects of public significance.

Of course, it is possible to achieve the so called 'cornering the market,' where a small number of investors buy up a large number of bonds of small nominal (or market) value. This phenomenon reflects the need of any economically stronger market participant to take up the most favorable position, and – in addition to the profits from the market transactions –

[250] Štimac, ibid, p. 63-67

secure profit from rent keeping. At the middle of 1930s, such was the practice by a group of larger investors with the bonds issued as compensation for war damages. Considering the weaknesses of the then-fledgling regulations, such operations were not sanctioned[251]. There was a similar situation immediately after the issue of old foreign savings bonds, most of which ended up in the hands of the four large banks in Serbia.

Today, it is more a case of an exception to the rule when regulatory authorities of the capital market react. Even before their reaction, the system of the capital market itself was much more diversified and well-established. Therefore, it was much harder and more expensive to corner the market. The city of Novi Sad bonds, the first municipal bonds on the Serbian market, have had a strong placement from the very beginning. All due diligence was completed prior to the issue, making them safe from malpractices. Since they have served as a model for designing the regulations in the Securities Commission, it is safe to say that this will be the case with all the other future municipal bonds.

IV.6.5. Correlation between debtors and creditors

As we have already pointed out, bonds represent a formalization of the debtor-creditor relation. On one side, there is formalization of a payment promise of all due perquisites by way of assets taken from the sale of the bonds; on the other side, one of the basic conditions on which economy rests is fulfilled – the formalization of expectations. Finally, when investing in any business, investors do not have at their disposal anything more than expectations of profit from the transaction.

Bonds turn this expectation into a numeric indicator of value, time and the relation of value versus time. Such formalization is implemented to the degree that municipal and government bonds alike have been typically considered to be the safest investments. This is rightfully so, with the exception of in times of crises. However, crises are intermittent and considering the regular economic flows, rare and short-lived, with the tendency to rectify what has been proven uneconomic in the usual economic flows.

[251] It was almost a public secret that Milan Stojadinović, then premier, was involved in the operations. However, such a thing was never proven, and it could be disregarded as small town rumor and journalistic sensationalism.

Bonds tie with the same expectation both the debtors who issued them and the creditors investing in them. Such a link is firm and strong, and it cannot be broken, even if transferred from a creditor to a creditor, save for their maturity. That is why this kind of a security introduces a high level of security and stability into its economic flows. The stability is firstly and primarily an economic one; market participants, be they buyers or not, are given the reference rate relative to a certain period of time, enabling them to more easily calculate the cost of capital and risk of all their other transactions.

The transference of security goes from political to social, with bonds being formalized promises of the political government to utilize effectively the assets obtained from the sale of the bonds. The sale commits the government to particular economic and social behavior according the purpose of the bond issues. Bonds thus become a direct link between the economic and political segments of the social system; and even more than being a mere link, bonds are an instrument of attaining security and certainty in both of the areas.

IV.6.6. There is no openness without responsibility

Indirectly, bonds represent a means of building political and economic democratic culture. A bond investor is tied to the objectives of the bond, for which it has been issued. Even unknowingly, he identifies a part of his objectives with the goals and endeavors of the bond issuers, most easily at the level of the local government. At this level, the unity of the political and the economic is most easily attained as problems and interests are most easily discerned at that level to all members of a community.

The formalization of trust in relations, accomplished by the issue and placement of bonds, makes the democratic endeavors in a local community stronger, reverberating positive effects through the entire state. A state can be decentralized and meet all the formal criteria of a democratic community, but still be detached from the essence of what Karl Popper calls open society.[252]

[252] More about the existence of formal legal and political conditions of democracy and their (in)sufficiency to provide the essence of democratic processes, please see: Damjanović, Mijat, *Demokratija epizodna misterija*, 2011, Megatrend University and Official Gazette, Belgrade, especially from p. 237

Open society includes all the above mentioned as vital prerequisites, but the essence is only imparted by the processes which should be created and led in institutions of such a decentralized state at all of its levels, but primarily at the local level. The processes can be stimulated most easily by linking people with interests. Interests are the best teachers and the optimum cohesive power for members in a community. Expressing and serving interests, and this is where we have started here, should be directed to institutions following certain procedures. Thus we come again to bonds as one of the most formalized instruments of expressing and gratifying interests.

Moreover, not only do they utilize the shell of the open democratic society, but they impart essence to it and muster members of a community to use the institutions. In the long-run, they develop the character of society without which there is no sustainability of an open society, and they provide responsibility in actions of society members and institutions

- The wish to increase assets at one's disposal, and thus the wish to invest, stems from responsibility to one's own progress and betterment of the family; municipal bonds and government bonds alike provide this in the safest possible way;
- An issuer of bonds, a municipality for example, institutionalizes its responsibility in managing community policies and economic policy by formalizing its promise about returning the assets at a future moment; the responsibility is transferred, when their term of office ends, to any subsequent government until the moment when the bonds are due and mature, thus reinforcing the business and partly the social and political system in a community.

The business of issue, placement and investment management attracts an entire profession of people around bonds, living off the capital market; since the capital market is one of the most vital parts of economy, or it should be so in a democratic society, the institutionalization of responsibility reverberates from the capital market intermediaries through the rest of the economy and its participants.

IV.7. Open and responsible society

Constant efforts to expand shareholding can be expended in an environment Popper designated as open society. However, an open society alone with all of its institutions protecting it and providing development is not sufficient. Popper concludes, in one of his later interviews that 'democracy has never been', literally, people's rule nor can or should it be'. According to Popper, the key moment is attaining such a system that makes it possible to get rid of a government without spilling blood.[253]

From this point onwards, it becomes possible to gradually build all that we understand today under the terms 'democratic system" and 'democratic society." Finally, for a society to utilize all the benefits of an established democratic system and to become democratic itself – to become open society – democracy must be grasped more profoundly, and not just in the sense of the highest possible voter turnout in election years.

In the chapter on democracy, we have already spoken about the active essence of democracy, what it really is and what gives the spirit of democracy to established institutions. Activism is the characteristic which ties democracy and capital (with its market), as neither of them exist in static environment. Milan Grol says that democracy thus lives only through movement and creation. He asserts that where it stands still it actually does not exist, and that '... democracy lives not of words: it seeks action, as its fundamental notion is that there are no foundations for better living conditions without incessant perfecting of actions and perfecting of man, who creates it and through the action creates himself.'[254]

In order for a society to be democratic, constant interest is necessary among its members – open expression of their own interests and respect for interests of others – in all processes taking place in a society. This can be relatively easily and quickly accomplished with the expansion of shareholding and the ownership of bonds, especially if the

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[253] Karl Popper, *Lesson of This Century,* according to the Serbian edition *Lekcija ovog veka*, NSPM and Alexandria Press, Belgrade, p. 95–101

[254] Grol, Milan, *Iskušenja demokratije* (*Trials of Democracy*), Naučna knjiga, Belgrade, 1991, p. 83

latter are instruments of public debt. Ownership of shares and ownership of options increase the responsible relation to one's own progress and the betterment of one's own family.

Responsibility in this relation is transferred and amplified to other segments of ownership relations. Issuers must act responsibly in order to meet the requests of the owners of securities they have issued. For example, when local governments sell their debt instruments on the market, a relation of responsibility is established with creditors. intermediaries placing the debt and the final owners of bonds. This is how the network of responsibility is expanded. It is institutionalized through the capital market institutions and directly reflected in the entire society.

A change of government in an election does not necessarily mean full discontinuity. Elections are not always fully uncertain, simply because even newly-elected governments have to honor the previously-established obligations. Therefore, they must at least respect the adopted development policies and to implement them further, improving the economic and social environment instead of changing it.

By providing, in this way too, the essence to open society, we come to a new quality – a responsible society. Therefore, transition is ended in two phases: establishing preconditions for creation of open society, and establishing its essence by developing a responsible society. This path begins with the social and returns to it, but travels via the economic – through the capital market and the dispersion of ownership of equity and debt securities.

ADDENDUM

SERIA – CASE STUDY APPENDICES

V.1. Privatization and shareholding

After the fall of the Berlin Wall, privatization was the backbone of transition. It preceded and directly caused the emergence and development of shareholding in almost all countries which then began to build their civic societies with market economies and parliament democracies. The model of privatization gave impetus to the development of shareholding. The process of its expansion contributed to the development of civic society facilitating more than anything else the emergence of the middle class.

The process differed from country to country, according to the model of privatization used and applied. In this sense, Serbia is just yet another example of a transition country. It strove, as other countries did, to execute a certain model composed of some specific features inherited from the previous period the country had endured immediately before the onset of transition. Being at the end of the succession of transition countries, Serbia had the opportunity to use some of the processes that proved to be working in other privatization examples and to include them in its own model. Unfortunately, the mistakes that others had made were repeated to a great extent as well, though they could have been easily avoided.

As a consequence of the mistakes made, the development of shareholding suffered the most. The entire transition in Serbia suffered to the same extent, as the formation of the middle class did not find firm support for its development. That is why the entire reform process – of which in the aggregate, transitions are made – suffered as well. Moreover, even twelve years after the dramatic victory of the democratic choice of most of the society, some social groups seem not to have evolved from the 1990s in certain sad and tragic practices from which we wanted to separate and step into a better world.

Today, twelve years distant from that period, it is easy to say as we got smarter that apart from the wish for a change and progress, nothing else seemed to be clearly set out. Of course, there were clear and prominent program objectives, operationally elaborated to the degree that they stated what should be done on the first day, in the first week, first month and year of the democratic changes. [255] However, it is the fact that even today, it is impossible to hear in the main course of politics and economy in Serbia, the clear truth that there is no development of democracy without a free market, and that it is summed up in a word – capitalism.

The global economic crisis contributed to the non-committal and one-off orientation towards capitalism as something passé and kept only as a semblance, as if by inertia. The media, under strict control and at the level of the 1990s, report on quandaries of academicians from the leading universities, confirming this and advocating the building of a new system. However, there never is a clear projection of the new system. It is yet to be discussed, shaped and erected gradually.

Such viewpoints, if really accepted, would lead to various social experiments. Here in Serbia, we had a chance to live in such an experiment for five decades, pompously called the 'political system of socialist self-governance." As in any other social experiment, this one too suppressed democracy, controlled the economy and smothered political and personal freedoms. The degree of suppression of individual freedoms, including entrepreneurship, can be debated in such attempts to accomplish a better society by centralized management, all at the foundations of the enlightened teachings. However, the repression cannot be avoided.

On the other hand, what we today call capitalism has shown sturdiness and effectiveness, as a system of doing business and in the social relation system built upon it. This provided continuity to capital from the emergence of a goods and cash economy in small, isolated areas from the Ancient Age through the Middle Ages and the New Period – when it became a dominant form of organization of society – up to the present times. The crises hitting capitalism today, especially the current

[255] The program elements were formulated in a document prepared by the then non-government organization G 17 Plus, for the Serbian Democratic Opposition Parties, for the 2000 September elections.

one, are not the crises of capitalism. Rather, they are induced by deviations from the fundamental postulates that formed, sustained and made it develop. One of the greatest dangers in this regard is imposing controls over cash and total economic flows by the political elites, who are pretentiously called the state.

Moreover, it is the expression of not only incompetence, but also of cynicism and insufficient courage to defend the postulates of profession by facing the main course of politics and academia. It is claimed that the crisis, caused by the direct interfering of the state into economy – meaning abandonment of postulates on which capital rests and thus its negation – can be only surmounted by even stricter control over the economy and society, instead of returning to the tested postulates proven so far to be the best form of organization of economy and society. The constituent parts of these postulates are the development shareholding, wide dispersion of ownership, and responsibility and interest in the overall progress of society.

However, we still have not transcended the mental barrier towards private ownership and capitalism in Serbia, or it seems so from the course of reforms. It would not be just to blame only those who are in the position to make decisions and who have direct influence on the legislative processes and managing the processes in society in general. The intellectual elite, and the most vociferous among them, fully supported and contributed to the incompetence of the political elites.

In this game of fallacies, the most strident part of the cultural establishment in their philippics continuously blamed the private sector as the source of corruption, and they tied it to private property, often urging the state to reclaim some of the 'strategic" companies. Such actions considering one of the large companies usually would be preceded by a debated stirred in the media about the value of an industry or importance of a company for the entire country. Then, a media harangue would ensue, targeted at the owners, in which the 'independent" and 'honest" keepers of public interest would compete to demonstrate their stout-heartedness and in filing criminal charges.

It is not necessary to emphasize that these fallacies, derived and applied to the end, again threaten to establish arbitrariness of the state in the economy. Although they do not annihilate the formal and legal personal freedom of decision-making and choice,[256] they certainly render it senseless. As one of the consequences, the relativization of contractual freedom occurs ('the freedom of self-legislation"[257]) and returns it, by annihilating it, to an 'anonymous" and 'impartial" state. Even for this purpose, passing it as justifiable, non-observance of laws and abandonment of the principle of legality is advocated and urged; and independent regulatory authorities and the judiciary are criticized for not acting according to their sense of 'public welfare," though it is not defined by a single provision of law nor are such competencies vested in them.

It is arduous and impracticable to explain in such an atmosphere that such competencies should not even exist, that the 'general welfare" is determined by the supreme piece of legislation – the Constitution – and that it is not, nor should it be, in the purview of the regulatory authorities and the judiciary to adjudicate what is general welfare in individual transactions, and that such behavior would be an introduction of corruption. In addition, it is nothing more than swimming against the stream to explain at the moment that the state economy itself – as a non-transparent joining of public and private interests where usually the public interests suffer – is the source of systemic corruption in any such system.

Thus, privatization has never been finalized, and has remained an open process. One of the collateral adverse effects of such a condition is that the state remained for a long period of time the owner in a large number of companies and banks. Moreover, by amending certain laws, it excluded itself from being subject to capital market regulations, even to the degree that the wholly state-owned companies were formally and legally fitted to the state itself. The Securities Commission thus had a difficult time treating the state as any other shareholder. This brought about additional inequalities of capital market participants considering takeover processes, acting in concert, related parties and so on.

The self-proclaimed saviors coming from the intellectual elite had

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[256] For more details about the freedom of choice and decisions, see: David Held, *Models of Democracy*, Polity Press, Cambridge, 1988

[257] For more details about the self-legislation as expression of freedom and voluntariness in establishment of social relations in economic activities please see: *Leksikon temeljnih pojmova politike* (*The Lexicon of Fundamental Terms in Politics*), Školska knjiga, Zagreb, 1990, here quoted according to: Milan Matić, *Liberalizam, populizam i demokratija* (*Liberalism, Populism and Democracy*), Official Journal of SFY and Institute for Political Studies, Belgrade, 2002, p. 15-16

their moments of stardom, as politicians used them as an alibi for prolongation of the psychosis of uncertainty and fostering an environment for their own benefit.

As various advisers swarm around such politicians, whose advice mostly is for the personal gain, there are constant threats of arrest and dealing with the rich and wealthy – the tycoons, as the media call them – and constant cries against the injustice further diminishes the protection and respect of private ownership, legally acquired. The notions of privatization and trading on the capital market are consciously misused. Normal stock exchange transactions are being trumped up into precisely coordinated media affairs. Takeover bids are attacked as well, although they represent the most transparent way of purchasing shares. Finally, the capital market is systematically associated with frauds and swindlers. Of course, the facts refute this. The companies which were part of portfolio investments raised their business performances, often boosting the entire industries to which they belong. However, it seems that it is the openness and democratic character of the capital market that is most bothersome to those who aspire to be always at the steering wheel of the reforms, but never to complete them, as this would put in jeopardy their rent-keeping in the system.[258]

The crisis has helped us here to put off the final decision regarding something that, unfortunately, we are not able to recognize any more as the only form of organization of economy and society that brings freedom to each individual, each member of our community. In such an environment, regardless of all instances of privatization, it is difficult to facilitate the development of shareholding.

Still, strangely enough, the transition has developed, if not entirely by itself, then with the lone support of capital market institutions, but not from the whole system itself. At certain moments of the transition to date,

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[258] Such ostentatious reformism is a clear signal that the political system in Serbia has significant features of populism. Moreover, it reflects not only the conservative, but regressive and authoritarian nature of populism, which usually is insensitive to the real potentials of society, for public and general interests, but also too sensitive to any question that may affect the prestige, position and predominance of leaders and leading groups and the stronghold of the populist politics.', *Liberalism, populism and democracy* - *Liberalizam, populizam i demokratija*, Official Journal of FRY and the Institute for Political Studies, Beograd, 2002, p 119

it has even had some nice ascents. In order to establish it as a standing and sustainable system, clear orientation of the political elites is necessary, if not primarily towards shareholding, then towards capitalism and the fact that capital can be augmented when in private ownership, and only as an exception and in the short-run, when in state hands. When this orientation genuinely occurs, it will enable the development of shareholding and the capital market and all the positive effects it brings to an economy.

The legal and factual framework of functioning of the capital market is being improved by the European Union accession, through the process of gradual alignment of the regulations and their implementation. It is still true that this could have been done at least several years ago, if not a decade ago. With the changes in the capital market over a period of a decade, shareholding itself would become stronger and wider. This would certainly yield a different society, and therefore a different political backdrop of Serbian reality. In the immediate future, it will be interesting to follow the development of shareholding, which might occur with the mass distribution of shares of large state companies. What can be a deterrent in this process are clear indications coming from several sides that the time of EU integration for Serbia could be at least a decade away.

V.2. A brief historical overview

Whenever a new law was adopted that affected the capital market, arousing controversy, the drafters from the various governments, when confronted with the logical and undeniable arguments, would always reach for a final, intolerant and empty argument: What is good for the rest of the world is not good for Serbia, we are not ready for this, our economy is weak, we are too small to engage in this…

A quick glance at the historical articles would show that Serbia, whenever small and weak, did have a developed capital market. Moreover, the liberal capitalistic system, with the relevant parliamentary democracy, provided a foundation sound enough to steer it successfully through three wars – the third of which was the world war – and to preserve its institutions and currency, even during the exodus.[259]

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[259] To avoid misinterpretations: This is not an ode to Serbia, celebrating its history; this is an example of sustainability of capitalism, i.e. market

The development of capitalism in Serbia, and later in the Kingdom of Yugoslavia, had a flow not much different from the rest of the countries and markets of the Western Europe or the United States. The flow had its theoretical application in the 18th century. Then a bourgeois revolution ensued – the First Serbian Uprising – at the very beginning of the 19th century, followed by the succession of authoritarian and liberal regimes, in the course of which market institutions gradually developed. To the period preceding World War Two, Serbia produced a developed system of the capital market that contributed a great deal to the economic empowerment of the entire country at that time and protected it from numerous economic disturbances hitting other countries.

The first considerations of the role of a merchant and the turnover of capital in the general progress and welfare of society belong to Dositej Obradović in his works at the turn of the 18th and the 19th centuries. In his work *Mezimac* (*Favorite*), he equates trading with science and art, considering its importance for the good organization of society. Moreover, he believes that a nation cannot mature and reach perfection without trading, among other things,[260] and without nimble merchants.[261]

His kernels of his ideas, in tune with the main stream of Western thought at the time, fell on fertile ground. In fact, he gave theoretical foundations to the processes by which others participated in their everyday life for quite a while.[262] In the triangle where the Serbian people were scattered – from Trieste to Szentendre and Temisoara – capital and all of its features had been known as a notion for a long time. Trading flourished, intermediation thrived and contemporary accounting systems were kept.

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economy and parliament democracy.

[260] 'Сада Мудрость зида себи домъ, и утверждава га на седамь столпова: 1. на Наукамъ, на Художествамъ, 3. на Землъвоздъланію, 4. на Терговли, 5. на Законы, 6. на Человъколюбію, 7. на Правды.', and: '... али Науке, занати, кораблъплаванію и купечество, доводе благоплучіе Народнъ къ зрелости и совершенству.', Досіθею Обрадович, *Мезимацъ*, Печатнъ Кралъв: Мадьар: Свеучилища, 1818, Budim, p. 110 and 113

[261] Dositej Obradović, *Dela*, Državna štamparija Kraljevine Srbije, 1911, Beograd, p.275

[262] Please see for example: Др. Милош Раиђъ, , *Србски народни фондови*, Типографія Митрополитско-Гимназиална, Карловци, 1864.In this book, Dr Rajić presents the state of the Serbian national funds, formed based on the (clerical!) regulations dated from 1739, two clerical funds ten endowments (*заклада*) and two more deposits (*покладе*).

In such an environment, as soon as the first bonds and shares appeared, they became the subject of trading speculations, decades before the first joint stock companies were founded in Serbia. In the first half of the second decade of the 19th century, one could read in the *Novine Srbske* (*Serbian Newspaper*), then printed in the imperial Vienna, reports from the Vienna Stock Exchange about the turnover of bank shares. The newspaper itself from time to time featured calls for subscription and payment of new issues of shares.

Joint stock companies in Serbia began replacing the one-off trading partnerships of merchants as the first institutions of market economy and civil society gradually emerged, spontaneously, at the beginning of the 1820s. It continued to grow in an organized manner with the help from the state, when liberals came to power, during the Regency of Jovan Ristić. Progressive governments took the task over from the liberals, and by the end of the 1880s – mostly owing to the efforts of Čedomilj Mijatović – they succeeded in rounding the entire institutional and legal setting for the rapid expansion of shareholding.

In all fairness, the first step in that direction was made during the reign of Prince Aleksandar Karađorđević, by the adoption of the Commercial Code of Princedom of Serbia in 1860. Nevertheless, the most of the job was left to the 1868 Grand Parliament and the adoption of the new Constitution the following year, from which the subsequent regulations grew.

During the period of Regency, the first monetary institutions were established, first plants and first district saving associations (first savings banks).[263] The first Serbian bank was set up back in 1869 – as a joint stock company – and then, over the following two years, the Belgrade Credit Bureau, Valjevo Savings Bank and Smederevo Credit Bank were founded. Ten years later, under the government of the progressives, the Šabac Savings Bank was founded, as were – the Belgrade Mutual Loan

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[263] The Constitution from the period of Regency protected private property and established basic civic freedoms. Handing power over to the king when he came of age, Regency President Jovan Ristić claimed with some pride in his address to the National Parliament that life and property of all are now safe. Undoubtedly, for the real development of shareholding this was the right state of affairs, as is for the real development of the contemporary, democratic, parliamentary state.

Society and Obrenovac Mutual Loan Society, which resembled the first mutual investment funds.

The real development of shareholding in Serbia occurred due to the shares of the National Bank and the Belgrade Mutual Loan Society. Under the vigorous leadership of George (Đorđe) Vajfert, a.k.a. Luka Ćelović Trebinjac, these two financial institutions raised capital by issuing shares. Then they employed it in such a way that businesses of both institutions grew incessantly, and their shares were the most traded on the Belgrade Stock Exchange. The Stock Exchange itself, as an indispensable institution for the development of shareholding, was founded by the Belgrade and Serbian traders at the beginning of the last decade of the nineteenth century.

The market expansion after World War I added to the rise in economic activities. Share issues were common, and we may say, even the prevailing way to raise capital for the formation of new companies and expansion of business activities. The previously-developed legislative activities in all the countries and regions comprising the then Kingdom of all the South Slavs contributed to this. There were special laws in all the countries regulating the formation, operation, bodies, shareholder relations, etc. of joint stock companies. As time passed, and World War II and the demise of the Kingdom approached, the regulations slowly unified, facilitating the spread of shareholding and trading in securities, regardless of their location of issue, throughout the entire territory of the then-Yugoslavia. In 1937, there were 584 registered banks – joint stock companies – alone in the Kingdom.

The further development of shareholding was abruptly put to an end in 1941 and in 1944/5. Instead of a logical and fair system, we received an expensive mockery, where shareholding was not welcome. At the end of the 1980s, a weak effort was made to renew some of the institutions, including the stock exchange and joint stock companies. However, it collapsed soon after, when payment came due for the bills of the previous regime.

Fortunately, the seed of shareholding continued to develop in spite of the circumstances and the state during the 1990s. The group of privatization laws, especially the ones from 1997, provided a powerful spur. Finally, the October 2000 changes and a set of laws governing companies and the capital market gave an additional impetus to the development of shareholding.

V.3. Privatization in Serbia

Privatization in Serbia began prior to the transition. More accurately, privatization itself caused some changes in society and its structure; however, in the first twelve years, the changes cannot be called the transition, as they were not part of the total conscious orientation of the political elites toward opening all the processes which were to induce the creation of a civic society. Therefore, the changes were accompanying the several waves of privatization that had started in the time of the last Yugoslav government.

Each subsequent privatization was implemented following a different model, and their scopes where not the same, nor was the importance for the transformation of the economy and society. The first privatization was the so-called 'insider privatization." It started and it ended exclusively with the employees of the companies which were privatized. Then, further instances of privatization ensued, implemented by Serbian governments in the first half of the 1990s, but with weak – or from the today's point of view – zero effect on the social developments.

The first important, and to- date unmatched, privatization that opened the door to shareholding as a social and economic process was the privatization carried out in the second half of the 1990s. Its potential was not fully realized because in the environment at the time, it was an isolated process without support from other processes or institutions. It was the first to step outside the factory compound of the company being privatized. The capital was distributed to employees, then to all interested citizens who could subscribe ownership in certain companies in a straightforward procedure, and then, only at the end, to the state.

Owing to this, the state did not exceed the fifty-percent ownership threshold in either of the privatized companies. Concurrently, a wide foundation was set for the development of shareholding, as in addition to employees, all interested citizens became shareholders as well. An even without knowing it, the then authoritarian regime had opened a process that started to undermine it. With the growing political discontent, the regime also allowed gradual ownership and the economic emancipation of some social strata. However, this should not be given too much credit, and it should be emphasized once more that it was not supported by the system.

Moreover, where it could have been supported, where it even had to be placed for further development – at the stock exchange and the capital market institutions – it was prevented by an explicit provision of the law. The ones who made all the decisions back then had clearly in their education and personal orientation an inherent loathing of the stock exchange, as something representing the essence of capitalism and its 'filthiness." Thus it happened that the full, free use of shares acquired in this privatization was forbidden. The owners were able only to sell a block of shares at a time and only were granted the free use of each obtained share after the expiration of a six-year period.

It is quite a paradox to acquire something and not to be able to use it freely. To be fair, the good side of the paradox was that it protected the uneducated and the so-called reluctant shareholders, who were employees in privatized companies, preventing them from rushing to sell all their shares and driving down share prices. In the meanwhile, they had the right to vote attached to the shares. All in all, interest groups emerged which were able to fight over-gratification of their interests.

Privatization according to this model was carried out for several years, with its last big wave at the very end of the year 2000, when around one hundred of the most successful Serbian companies were privatized. To the time of privatization of the large state monopolies, this one contributed the most to the development of shareholding in Serbia. Even before the beginning of the true transition, it had opened the most important processes for the transition reforms. Its contribution to the development of the capital market was evident from the beginning of the year 2000 to date. The shares mostly traded on the Belgrade Stock Exchange – the backbone of its development, reaching the highest values during the everyday stock exchange trading session or in takeovers – emerged in that privatization process.

V.4. Irrational avoidance of the market

It was only logical to expect the development of the capital market as one of the pillars of transition into a civic society after the October 2000 changes. In this case, the logic gave way to some other interests, and the capital market remained on the margins of the main reform processes in Serbia. Here, the lack of logic in such action is even greater, if the simple fact is taken into consideration. Only privatization that took place in an institutionally-regulated environment was successful. The countries which had previously institutionalized their capital markets benefitted the most from their privatization processes; such privatization processes contributed to the strengthening of their economies and of the total transition process.

There were certain given circumstances which had to be resolved at the beginning of 2000s, before even thinking about the quality of transition. One of them, and certainly the most demanding, was the empty nation's coffers. They could be filled quickly only with the sale of companies in the continuation of privatization. However, for a quick replenishment of the coffers, the other model of privatization was necessary as well, as the other one from the second half of 1990s did not bring money immediately.

That is why privatization was continued following the model of the so-called investor privatization, the model that suited the most the buyers of companies. They were allowed to buy seventy percent of the company, and the rest would be divided between the employees and the other citizens. The buyers would immediately become majority owners of companies, and they cared little about the other owners. The lack of concern was substituted by the provisions of the purchase agreement, whereby the new owners had the obligation to preserve the core activity of the company, not to dispose of its capital and to pursue a certain social policy within the purchased company. The last was mostly reduced to allowed percentages of reduction in work force and the levels of severance payments.

The institutional set up of privatization was such that the state – through the competent ministry, the Privatization Agency and the Share Fund – was the largest seller, the operator of the sale process and the controller of the entire process. The latter two were under the competence of the ministry in charge of privatization, closing thus the entire process of privatization into a legal and business whole, separated from the rest of the market and the other institutions of the capital market.

These three functions had to be separated. Struggling under the burden of sale of a large number of companies, and by organizing opposing processes at the same time, no institution would be able to deal with it properly. Hence, it became evident during this wave of privatization that the separation of processes from their environment made their long-term positive effects insufficient, and in a number of cases even harmful to the environment.

Developed on a number of forced moves, such a privatization had the destiny as anything rushed and pressed would have. The example of use of the old foreign currency saving bonds illustrates this. The bonds were intended to compensate the depositors for their loss, which occurred when the previous regime in the 1990s had spent the entire foreign currency savings deposited in commercial banks – without any compensation or explanation – bypassing the law. –. After the 5th of October changes, the new government, aspiring to become democratic as soon as possible, undertook to remedy some of the wrongs from the previous period, this one among them. The only feasible solution was to issue bonds and pay out the damages in accordance with the foreign currency deposit spent.

However, the government treasury was empty, and the bonds matured for payment. Again, the government resorted to a forced solution. It was allowed to use the bonds to pay for the companies which were not sold in the first two auctions. It was possible to use bonds on the third auction as a payment in their full nominal amounts. At the same time, it was possible to buy the bonds on the Stock Exchange at a discount that matched their maturity. Thus, an option was opened to buy companies for government debt, which was annulled in this way.

However, this also opened up the space for speculation – to buy bonds at a deep discount and then to purchase companies using the bonds at their nominal values – on privatization auctions. In this way a solid price difference could be achieved, motivating speculators more than others. Speculation itself on a capital market is not harmful. On the contrary, it provides a dynamic environment and the necessary liquidity. Still, privatization is not a process exclusive or restricted to the capital market; it is a strategic process of transformation of ownership that makes the backbone of transition.

On the other hand, speculators are interested in gaining quick profit from differences in prices, and not in long-term investments and saving of the fallen companies. It is noteworthy that payments of companies using bonds were only allowed as a means of payment on a third auction, meaning that there were no interested parties on the first two, primarily because of the state of the companies. Only their employees had the motive for sustaining them and increasing their business activities. However, they ended up in the hands of those who treated them as nothing more than a set of real property, as in this way they could make profit on their investments in a short period of time.

In order to mitigate the consequences of the rushed and forced actions, which marked this process of privatization, all the privatized companies were treated as public joint stock companies and were registered on the Belgrade Stock Exchange. However, because of the basic characteristics of the privatization model, trading in the shares of these companies was driven in a large number of instances by the need for the further concentration of ownership and for finding the price at which a takeover bid can be made for the rest of the capital. It was helped by the fact that Serbia did not get a special law on takeovers of joint stock companies for a long period of time. However, this way of buying stock was made possible through the law on the market of securities, which regulated this matter and allowed making takeover bids only considering a part of the capital, rather than the entire capital of firms.

V.5. One attempt at remedying shortcomings

The main weaknesses of such a model of privatization were observed relatively early. One of the institutional attempts at minimizing the weaknesses concerns the 2004 term of office of the National Assembly. In its open and public sessions, the then-Privatization Board examined the complaints coming from a large number of shareholder representatives of privatized companies. The Board adopted a separate document for each company for which it assumed that there was a method for resolving concrete problems. The document was then referred to the competent minister and the Privatization Agency.

Based on what was presented, the Board made the recommendations for fixing the privatization process. The recommendations started from the fact that privatization was a multilayered and complex process whose direct goal was a more efficient economy, not the mere transfer of ownership from society or the state to an individual or groups of individuals. The transfer of ownership is a means for achieving a more efficient economy, as economic performances of private ownership exceed those of other forms of ownership. Therefore, privatization is to clearly divide the functions of management and ownership and the position of labor in companies. A legal solution defining this process should have facilitated nothing less than this.

Privatization in transition countries has an indirect, but equally important goal as well. It is the essential process in the set of processes we call transition. It should spur the formation of the middle class that Serbia lacks. Especially, it should affect the change in the general perception, cultural model and change of priorities in the system of moral values, over a short period of time. Of course, it is not to be expected that the entrepreneurial spirit could be found in everyone; it could not and should not be so. Privatization should make the widest population possible face (economic) reality and animate their mental transformation from being dependant and easily manipulated – those who only wait to be given something (by the state or 'master") – into the state of individuals responsible for their own economic or political position.

The privatization model which was applied in Serbia from 2001 was forced in many aspects, as we have seen. However, as it has been pointed out on several occasions illustrating the comparative experiences of the transition countries, the problem did not lie in the model itself; it came from the lack of institutions where the processes should have developed and in the lack of instruments to affect the process.

Finally, there is the fact that the processes which were to relieve privatization of a burden of additional inefficiencies, problems and contradictions were not initiated. This is equally valid for the reform of judiciary and the clear definition of competencies of the institutions; and it is perhaps most true for unregulated denationalization and restitution. The latter even placed the state in a situation to sell something that did not belong to it, passing the problem to each subsequent government, further aggravating and deepening the problem.

The companies which were sold at auctions and tenders ended the first phase of privatization at the time when the Assembly was constituted in 2004. It was envisaged for the post-privatization process, in accordance with the purchase agreements, that buyers (a) invested new assets in companies, in predetermined annual amounts, (b) provided a social program, most often reduced to severance payments, and (c) did not to sell more capital than envisaged by the agreements, amounting to ten percent for the first year.

As soon as the Privatization Board was established, twenty complaints concerning individual privatization cases piled up. Here, at the very beginning, the depth of the institutional vacuum manifested itself. As stipulated by the Law, the complaints were to be resolved by the Privatization Agency and the Ministry. However, these were the institutions which had organized the privatization process, in the first place. The differing interpretations from the Agency and those who filed the complaints spoke volumes about the collision of the two functions – organization of a process and its control.

On the other hand, the Privatization Board should not discuss individual cases. It is a body of the Assembly, the carrier of sovereignty and the highest legislative power in the country. The bodies of this institution should deal with the issues from the strategic level of process management. Therefore, the Privatization Board should have dealt with the process as a whole and its enhancement. Nevertheless, the Board decided to deal with the individual cases in the first month of its work. Based on the errors observed in those cases, the Board was able to find ways of overcoming them and for advancing the privatization process.

Several interest groups swarm around any privatization. The state and shareholders, workers and investors, and management alike have short-term and strategic interests in privatization. The interests mostly collide, which does not necessarily mean that they exclude one another. The Board received complaints from the employees, small and non-controlling shareholders, and from the buyers and management. When the Board started to work, the number of complaints snowballed to 130 within three months. Over the time that the Board discussed the individual complaints, the number did not exceed ten percent of the total number of privatized companies. However, the feeling of anxiety remained that the number could soar with the end of the first phase of privatization in each company, owing to the systemic error built in the privatization model.[264]

[264] Unfortunately, the fear came true. By the end of 2011, the percentage

The Board did not use the interests of the groups as a final criterion; instead, it was guided by the main goal of privatization – a more efficient economy. The methods of work used were defined by the line laws and the Standing Rules of the Assembly. In certain cases, the documents pressured the Board, either indirectly or through their media – the strongest means – but did not necessarily yield results. The limited powers of a board of the Assembly made the understanding and cooperation of the Agency, the body of the executive power (sic!), the key factor for the success of the Board's actions, the body of the supreme power (sic, sic!).

After three months of deliberations on individual cases, the Board decided to group all the privatization problems presented to it and to propose certain solutions. The problems and the proposals were grouped into four sets.

1. Privatization procedure
2. Post-privatization processes
3. Control of privatization as a whole
4. Development of shareholding

The Board proposed within the first group of problems, inter alia, to introduce free distribution of shares to employees instead of the third auction principle. The most important solution proposed in the second group of problems was to exempt the control function from the Privatization Agency and to transfer it to another institution outside the privatization system. The Board had the opinion that the capital market regulatory authority – the Securities Commission – was the most suitable for this, as all the privatized companies were given the status of open joint stock companies.

The resolution for the third group of problems stipulated the control of auditors and a more comprehensive role of institutions dealing with the prevention of money laundering. Finally, the solutions aimed at protection of shareholders were proposed, from the area of corporate

of unsuccessful, annulled privatization cases went up to one fourth of the sold companies, where the Agency practically re-nationalized the companies. (author's remark) governance and takeover bids. It was demanded that they should not be partial, but refer to the entire capital of the offered companies.

The thoroughly and ambitiously prepared strategy for the enhancement of the privatization process – which included the entire Board, regardless of their partisanship and whether they belonged to the ruling coalition of parties or to the Opposition[265] – unfortunately, did not produce any effects. It was simply ignored by the competent institutions. The subsequent governments also did not pay attention to this initiative of the Board, but under the pressure of events and cries for reforms, they made several moves recommended in this document. Some of them made the quality of privatization better. However, as it was at an advanced stage, such an improved model could be applied only to a small number of the remaining non-privatized companies.

V.6. Legal framework for the development of shareholding

Until recently, misunderstanding and pushing aside shareholding and the capital market and its institutions has been a characteristic of the transition process in Serbia. One after the other, the two laws adopted in the 2000s to govern the regulation of market of securities diminished the powers of the Securities Commission. The market continued to develop and evolve formally, legally and commercially only with the persistent efforts from the Stock Exchange, Central Securities Depository, Securities Commission and some of the intermediaries.

International financial institutions expressed their full appreciation of the efforts, grading them highly. The Securities Commission is thus an ordinary member of IOSCO, group A. Finally, as part of the alignment with the European Union *acquis*, the area of the capital market has been governed in accordance with the highest standards. The Law on the Capital Market, adopted in 2011, set such framework, together with the supporting laws and their changes, concerning units for collective investments – funds and takeovers of joint stock companies.

Shareholding as a strategic process still keeps running into

[265] All the Board decisions, those about individual privatization cases and those formulated as the strategy for its enhancement were being adopted unanimously. It speaks in favor of their well-foundedness and legality. (author's remark)

obstacles.[266] The law which regulates equity companies contains an absurd threshold for companies that go public and that become open joint stock companies. In order for this to happen, a company must have ten thousand shareholders (!). In most of the countries the number is five hundred. Let us reiterate, the rules and principles of political and economic democracy alike – shareholding – need to facilitate the adoption of decisions about processes concerning all the interested parties, but who do not know each other because of their large number. It is a matter for discussion, whether the threshold should be five hundred or seven hundred or some other number of direct participants; however the number is certainly less than ten thousand.

Further, the threshold for squeeze-outs was lowered from 95 percent to 90 percent. The significance of this change remains to be seen when the large state monopolies are privatized. Their capital has been distributed to all Serbian citizens of age, and if the previous conditions are met, it is possible to divest ten percent of adult population of their constitutional right to manage their private ownership.

The most significant event for the development of shareholding in Serbia – finally equaling the positive effects of privatization of the second half of the 1990s – is the distribution of shares of Naftna industrija Srbije (Oil Industry of Serbia), Aerodrom Beograd (Belgrade Airport) and Telekom to all adult citizens. There were fears that such a distribution would have no effect at all, that mass selling of shares would follow their distribution. However, as opposed to the notorious example of bad privatization in the Czech Republic, by the time the shares were distributed, Serbia had developed capital market institutions with the experience of two decades. They stood up to the challenge, both business-wise and technically. For example, there were instances when, at peaks of trading, no fewer than 300,000 transactions were settled in a single day.

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[266] Professor Matić explains the numerous obstacles to the development of economic system by the fact that at the time of the first accumulation of capital in Serbia the market was not an inexorable factor of the economically capable and vital. The closed circles of the political elites were comprised of the economically uneducated and competent people, who then appeared as factors deterring, blocking or even frustrating *economic developments, the important condition for democratic changes* (italics by M.Š.) – Milan Matić, *Liberalizam, populizam i demokratija* (*Liberalism, populism and democracy*), Official Gazette of FRY and the Institute for Political Studies, Belgrade, 2002, p. 124

However, it is most reassuring that the attitude of the widest population to shares has been changed. The behavior of reluctant shareholders – those who have received their shares and who did not buy them – was very different. Most often, the first takeover bid would be seized for the sale of shares, in order to obtain what they recognized as a sure value – the money. One piece of information is particularly illustrative of the change which has occurred in the investment climate in Serbia over the last ten years. The Gaspromnjeft takeover bid for the rest of the capital of the Naftna industrija (Oil Industry) was accepted by less than six percent of small shareholders in Serbia.

It can be concluded that a share has been recognized and acknowledged as a store of value. It spurs hope that the story of shareholding will manage to unfold on these foundations. And the story then can become the foundation for what the topic of this book has been – the support to development and preservation of democracy. However, it is necessary to remove yet another, significant obstacle on the road of its development, which is equally tied to political and economic democracy.

V.7. Centralization of the system

It is obvious that there is no democracy in centralized systems. If there is, it is weak, and the economy and society in such systems show serious defects in economic and any other development. When it comes to Serbia – where decentralization of the system was annulled during the times of the dictatorship – it has not fully recovered. Not more than several months ago, the initiative to amend the legislation regulating public debt came to life, allowing local governments to take loans. This meant that municipal bonds could be issued as well. Last year, there were four cities which received a rating from the international rating agencies. However, only the city of Novi Sad seized this opportunity to issue bonds.

Centralization as a key feature of the economic, and other segments of Serbian society, has not been conquered. It has taken the form of a specific bank-centered system. Not only is the entire system is dominated by several commercial banks, but the National Bank of Serbia shields them, often interfering in their business policy. Moreover, the National

Bank itself also operates commercially, encumbering the operations of commercial banks and the economy in general.

In this way, assets are concentrated in the National Bank and several commercial banks, and they are circulated among themselves and the Treasury. The largest portion of the assets is not transformed into capital by its active employment on the market. For years, the capital market has participated with not more than five percent on rare months in the value of transactions of the total financial market, and most often it amounted to three percent share.[267] The rest was the value of transactions in short-term instruments, issued by the National Bank of Serbia or the Treasury.

Large sums of money were drained away from the market, and the interest on the transactions was divided among a narrow, and we dare say, too narrow circle of participants. The market itself suffers from constant capital deprivation, reflected in its high market value. If the economy and local governments would even opt for issuing shares, i.e. bonds, they would face the fact that there are no ready funds on the market; and any which were available, would come at an excessive price.

The fact that we are among the rare countries in which the central monetary institution is at the same time the regulator of the insurance industry and the industry of private pension funds further aggravates the situation. Although these are capital market participants *per deffinitionem*, the assets collected here have been subjected to heavy and cumbersome procedures and to conservative control instruments of the National Bank, which admittedly should not be other than conservative.

The liberation of the two groups of capital market participants from the procedures of bank regulations – and returning them to the regulation and the entire group of the capital market – would contribute to true decentralization of the economic and, therefore, the political system. Only then, would it be possible to achieve symbiosis between the interests of the largest stakeholders, in order to finance companies and local governments, whose issues of shares and bonds would then benefit from a much larger pool of prospective investors.

[267] For more details please see the regular reports of the Securities Commission on the state of the financial market: www.sec.gov.rs

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A NOTE ABOUT THE AUTHOR

Milko Štimac has been active in the field of the capital market for twenty years. The activities include the work on the stock exchanges of Chicago and Belgrade, leading the Privatization Committee of the National Assembly of the Republic of Serbia, and the Institute for Economic and Social Research, followed by a ten-year period serving as a Chairman and a Commissioner of the Serbian Securities Commission. It includes numerous research activities, participation at conferences in the country and abroad, in task forces and projects, publication of articles and several books, of which he considers the most important: *Srpsko berzansko poslovanje* (History of Stock Exchange Trading in Serbia) and *Osnove berzanskog poslovanja* (Fundamentals of Stock Exchange Operations). His special efforts were devoted to drawing together the capital markets in the Region (SEE).

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