FOREIGN INVESTORS COUNCIL

WHITE BOOK

Proposals for Improvement
of the Investment Climate in Serbia

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2007

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FOREWORD

Another year is behind us. We think that a good starting point for this year's review is to remind ourselves of a key sentence in last year's White Book: „2006 is likely to be one of the most challenging years the country faces". Indeed, that was the case.

After a good start to the year, May brought the first serious difficulty: SAA negotiations with the European Union were suspended due to lack of cooperation by the Serbian Government with the ICTY. This presented the first crisis of the Government. The turbulence on the political scene, although overcome, caused a slow-down in the reform process.

Next came Montenegro's independence referendum, resulting in the majority of people voting for the establishment of an independent state and the dissolution of the State Union with Serbia. The good news is that the process of separation was smooth, leaving the Republic of Serbia as the clear successor state of the former State Union. The not-so-good news is that there remain outstanding legislative changes that are required to reflect the new situation.

A number of these legislative changes were incorporated into Serbia's new constitution. After a positive public referendum, the Constitution was adopted by the Parliament in November. This was also Parliament's last major act before new elections were called. The Constitution brought some positive and important features, especially for foreign investors. The Constitution provides for and recognizes private property and free market economic activity. Ownership of real estate is now finally possible.

Another important event in 2006 was the signing of the CEFTA Agreement. For us, foreign investors, this is good news because we are now looking at a free trade area of over 20 million people. Some initial problems affecting the position of the tobacco industry, where major foreign investors are present, have been overcome with the Government's adoption of an Action Plan which compensates for detrimental effects of CEFTA on the tobacco industry. The Plan has successfully met all the concerns expressed by the industry.

Finally, 2006 will be remembered as the year in which the official negotiations on the future of Kosovo began. At the time when this White Book is officially presented, no definite solution is yet in sight. But we would like to point out that, as important as the Kosovo issue is politically to Serbia, it is not perceived as a major political risk by foreign investors. Indeed, the year 2006 brought in the largest amount ever of foreign investment, to the tune of almost $4 billion.

Economically, 2006 had a number of positive accomplishments such as: lower than predicted inflation, record foreign currency reserves, stable exchange rate, solid real GDP growth estimated at 6%, record expansion of exports, and, the already mentioned high foreign investment. But a number of problems overshadowed these positive results: unemployment remains very high; restructuring efforts slowed even further; government expenditures remain too high (resulting in an excessively restrictive monetary policy); the trade deficit widened; increased concern over foreign indebtedness; and, privatization also lagged behind schedule, leaving about a thousand companies still not privatized. Even the accomplishment of the large foreign investment inflow is minimized somewhat given that the bulk of the capital was related to privatization with very little going into new or greenfield investments.

So what do we, as foreign investors, hope to expect from the Government in 2007?

First and foremost, we feel that the Government's central focus should shift back to the economy and the well-being of Serbia's people. This means the rapid resumption of economic reforms, the acceleration and completion of privatization, and the development of privatization/restructuring plans for major public companies such as NIS, JAT Airways, etc. The Government should also focus on maintaining stable macro-economic conditions, exercising prudent public spending, and promoting policies that will encourage entrepreneurship, innovation, productivity that will, in turn, promote gainful employment, stimulate rapid and stable growth, and improve the country's current unfavorable competitive position in the global market.

On a more concrete level, we believe that more attention should be paid to passing legislation that will complete the market economy. The newly-adopted constitution needs to be complemented by appropriate laws and by-laws as soon as possible. A number of useful suggestions in that direction can be found on the pages of this book. We also believe that there should be more of a balance between the passage of new laws and ensuring their implementation. So far, the latter has been somewhat neglected. Furthermore, public tendering procedures should be more efficient and transparent so that problematic situations like the Bor mining complex, the Prokop railway station, and the Horgos-Pozega (to name just a few) will not be repeated. We also strongly support the battle against corruption that has been initiated but urge the Government to continue this effort with more energy. If we add to the above list the issue of greater transparency in decision-making and a more efficient procedure for establishing operations, the conditions will be such that Serbia will be far more attractive to future foreign investors. Then, the Government can rightly expect to draw at least €3 billion annually over the next 5-6 years; the amount deemed necessary to sustain 7% in real growth of the economy.

The Foreign Investors Council is of the firm opinion that there is no alternative but to overcome the obstacles which resulted in the suspension of negotiations with the EU. Negotiations should be resumed as soon as possible and Serbia should accelerate its movement toward the European Union, with a view to signing the SAA later this year and becoming a candidate member next year.

While fully understanding the position of Serbia's people and government with respect to Kosovo's future, we expect that Serbia will not be placed on a confrontational track with the majority of the Security Council and European Union. From an economic and business perspective, this would be counter- productive.

Again, 2007 will present a number of new challenges for Serbia, the government and FIC members. We believe that the White Book can assist the government in navigating some of these challenges and, in turn, move the country towards an improved business environment conducive to capturing even higher levels of foreign direct investment and the benefits (job creation, exports, income, etc) that accompany foreign investment.

Budimir Bosko Kostic
FIC President and Spokesman

FIC OVERVIEW

Almost five years ago, 14 major foreign investors in Serbia, with the support of the OECD, gathered around the common idea of contributing to the improvement of the investment environment in Serbia.

Throughout past years, the Foreign Investors Council has proven to be a powerful, constructive and, therefore, respected reference tool on matters related to the development of the overall business climate. Today, FIC counts more than 110 members with representatives from more than 20 different countries. Involved in a wide range of industries, FIC members represent more than three-quarters of total FDI in Serbia and employ significant number of the local labour force. The organization is alive and continually growing.

Following its mission and striving to fulfill its aims, the Council has always worked in close partnership with the relevant government authorities, international organizations and institutions. Its main purpose is to share positive international business practices with local authorities and support their reform activities. Therefore, the FIC is constantly involved in both formal and informal dialogue between willing stakeholders. Activities in the past year included the organization of several FIC round tables, panel discussions and conferences; participation in and support for many non-FIC events; ongoing and continuous servicing of the membership; and, of course, dedicated work on the White Book. Most FIC activities are initiated by the members themselves and developed through the work of specialized Committees that cover most of the members' interests and needs: Legal, Insurance, Real Estate & Construction, Media & Communications and Human Resources. These are some of the topics that bring together FIC members on a regular basis. FIC provides a good platform for the exchange of experiences and opinions among its membership.

During the past year the Foreign Investors Council experienced several changes. Not only were there personnel changes within the Board of Directors, Executive Director and the FIC President, but the FIC office moved into new premises. All these changes, together with the "Way Forward" for the next year, were approved at the Annual General Assembly.

The 2007 plan includes two new initiatives in the work of the Foreign Investors Council. For the first time, the White Book has been prepared in cooperation with the Serbian Chamber of Commerce. The Council is grateful to the Chamber for the valuable contributions to this year's publication. From now on, the White Book will continue to be a cooperative effort. After all, foreign investors are also members of the Serbian Chamber of Commerce and, hopefully in several years, the FIC will have no reason to exist as Serbia readies to join the EU.

Second, FIC would like to publicly announce that this year it will launch a new publication: the Green Book. This publication would also follow upon initial FIC aims to stimulate new foreign direct investment in Serbia and maintain ongoing support/assistance to the international business community. The Green Book would target potential new investors around the globe and focus on sharing the experiences of present investors, and their successes, of doing business in Serbia.

In the future, the Council will continue in striving to build-up good partnership relations both with state authorities and other relevant stakeholders. FIC has already engaged in close cooperation with

like-minded business-oriented organizations such as the American Chamber of Commerce and others to collaborate on events and activities that support overall improvement of the foreign investment and business climate.

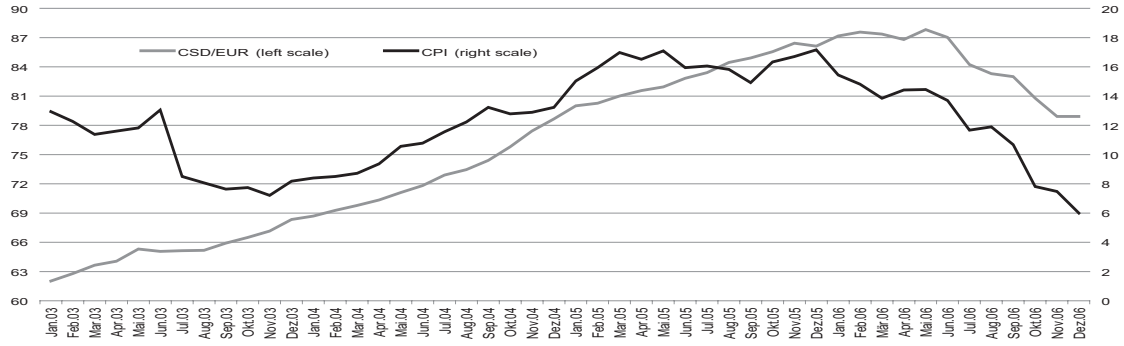
COUNTRY ECONOMIC OVERVIEW

ECONOMIC PERFORMANCE IN 2006

Economic slowdown continued in 2006 – With real economic growth of 5.7% in 2006 the Serbian economy lost some further momentum in 2006, after recording a robust 8.4% and 6.2% in 2004 and 2005, respectively. Consequently, nominal GDP has reached slightly over €24.3 billion, corresponding to a GDP per capita of some €3,200. The main reason for the economy's slowdown was on the production side and slower growth in the services sector (mainly in wholesale and retail trade), itself a result of the population's decreasing consumption propensity stemming from a more restrictive approach by the National Bank of Serbia (NBS) with regard to credit policy. On the other hand, the primary sector, which still generates some 15% of gross value-added, showed signs of recovery as compared to the drought-induced decline in agricultural production in 2005. However, industrial production gained some momentum, especially in mining and manufacturing, on the back of progress made in corporate restructuring in privatized industries. The construction sector developed robustly, fuelled by brisk investment activity. On the demand side, domestic demand remained the main pillar of growth. Nonetheless, private consumption grew more slowly, as is indicated by moderate retail sales growth, given the monetary restrictions imposed by the NBS in the first half of 2006 with a view to curbing credit growth. In contrast, investments have picked up, given major successes achieved in the privatization of state-owned enterprises. Public consumption also accelerated toward year-end 2006 in the run-up to early elections. Although exports grew nearly twice as fast as imports, the foreign trade deficit widened given the higher base level of imports.

Labour market rigidities prevail – High unemployment, currently at 33% (ILO: 21%) remains one of the key challenges for the Serbian economy. However, 2006 brought no improvement in labour market conditions. The unemployment rate increased from 32.6% on average in 2005 to 33.2% in 2006, while employment decreased by an estimated 1.5% given ongoing restructuring in the corporate sector. Growth of real net wages accelerated significantly in the final months of 2006 against the background of the government's more generous wage policy ahead of early elections, putting the average growth rate at 11.4% in 2006 (2005: 6.4%). At the same time, labour productivity grew by 13.5% (2005: 9%), although in light of developments in employment most likely not on the back of efficiency gains but as a result of restructuring-induced labour shedding.

Inflationary and exchange rate developments in Serbia
(2003-2006)

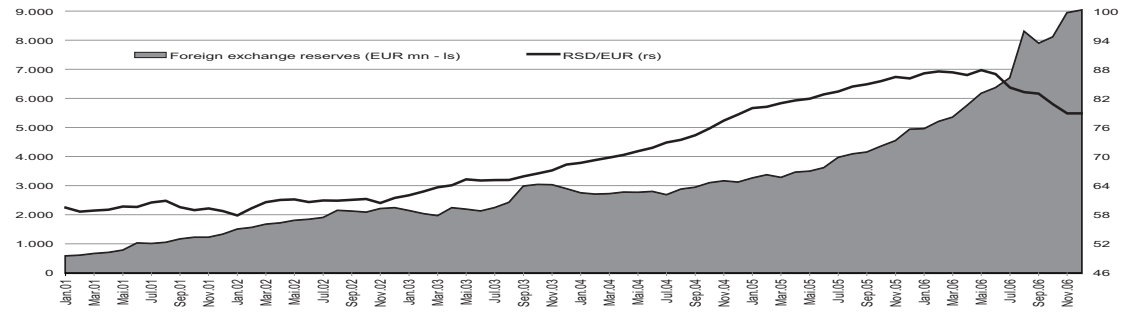


Source: NBS, UniCredit Group New Europe Research Network

Favourable inflationary environment triggers monetary relaxation – Underpinned by a strong national currency and falling energy prices and despite an easing of fiscal discipline, in the course of 2006 the NBS succeeded in bringing down inflation from 17.1% year-on-year (yoy) as of year-end 2005 to 6% yoy a year later, with headline inflation averaging 11.7% for full-year 2006 (2005: 16.2%). Core inflation fell to 5.9% as of year-end 2006, well below the NBS's 7-9% target band. Given the favourable inflationary environment and the sustained strength of the Serbian dinar (since 25 October 2006 ISO-Code: RSD), in the final quarter of 2006 the NBS eased its restrictive monetary stance on which it embarked in the second half of 2005 to dampen credit growth by considerably tightening minimum reserve requirements (in particular with regard to banks' foreign exchange liabilities) and introducing restrictive administrative measures. Starting from September 2006, the NBS has also formally adopted an inflation targeting monetary policy framework. Since then the NBS lowered the policy rate (2-week repo rate) in four steps by a total of 400 basis points from 18% to 14%. Above and beyond the rate cuts, the NBS further eased monetary policy by reducing the minimum reserve requirements on dinar deposits in two steps by 8 percentage points to 10% and setting the minimum reserve requirement rate on foreign exchange deposits and external borrowings of banks at a standard 45%. At the same time, however, the NBS decided for a stricter interpretation of loan-loss provisioning and prudential requirements on loan re-negotiations.

Huge capital inflows strengthen the RSD – Easing inflationary pressures were in particular the result of the strengthening of the Serbian currency, with the RSD appreciating by some 10% in nominal terms in the second half of 2006. This in turn can be attributed to robust FDI and long-term credit inflows. In fact, Serbia garnered significant privatisation revenues in 2006, including €1.5 billion from the sale of the telecom operator Mobi 63, which was sold to Norway's Telenor in mid-2006. But the sale of a mobile telephone license to Telekom Austria for €320 million, the acquisition of Panonska banka by Italy's SaoPaolo IMI (€122 million) and privatisation receipts from the sale of Vojvodanska banka to Greece's NBG (€385 million) also underpin the record 2006 year in terms of FDI. Thus, total FDI inflows are most likely to have reached €3.2 billion in 2006 as a whole, the best result since the beginning of the transition process.

Foreign exchange reserves
(2000-2006, EUR mn)



Source: NBS, UniCredit Group New Europe Research Network

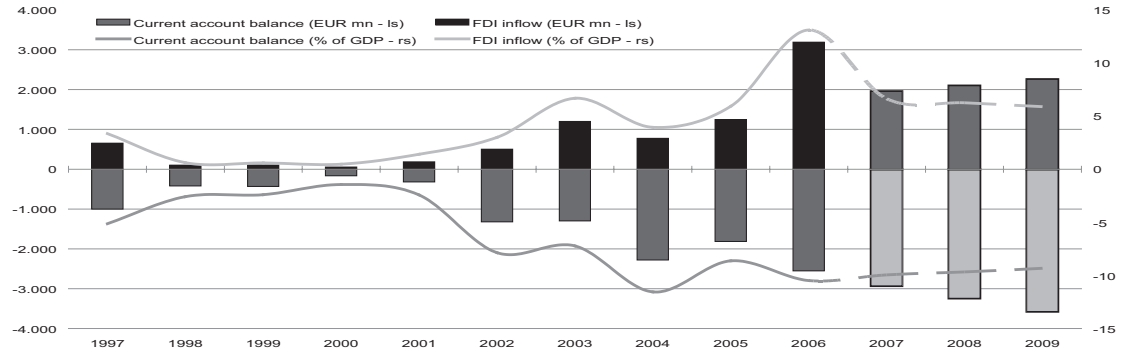
FX reserves at record levels – Although in its fight against inflation the NBS is in favour of a hard RSD, it nevertheless intervened against the dinar on the foreign exchange market on numerous occasions in 2006 (reaching a total volume of some €2 billion) in order to dampen the upward pressure on the national currency. Due to foreign exchange interventions and strong FDI inflows the country's foreign exchange reserves have grown by a total €4 billion to €9 billion in 2006. Hence, import cover rose from 6.3 months in 2005 to 9.2 months in 2006. In light of the higher reserves, after two transactions in June and September the NBS again made an early repayment of outstanding debt to the IMF (€175.8 million) and the World Bank (€321.5 million) in December, bringing total early repayments to the international lenders to €880 million in 2006. The remaining outstanding debt toward the IMF worth some €220 million was repaid in March 2007. Despite these repayments and debt write-offs against the Paris Club creditors (e.g. Italy), Serbia's total external debt increased from €13.1 billion or 59.2% of GDP as of year-end 2005 to €14.2 billion or 61.3% of GDP due to increasing indebtedness of the private sector, mainly corporations and banks.

Persistent external imbalances – With FDI inflows and foreign exchange reserves at record levels, the financing of the current account deficit, which after a VAT introduction-related temporary narrowing in 2005, again reached double-digit figures in 2006, does not appear to be a problem. The widening of the current account deficit from €1.8 billion or 8.6% of GDP to €2.5 billion or 10.5% of GDP can be mainly

attributed to lower current transfers, and a widening trade deficit despite a 40% expansion in exports of goods and import growth of 20%, although the latter from a much higher base. Serbia's main export partners in 2006 were with a 14.4% share in total exports Italy, followed by Bosnia and Herzegovina (11.6%) and Germany (9.9%). Serbian imports originated mainly from Russia (16.3%), Germany (9.5%) and Italy (8.3%).

Easing fiscal discipline – Given external imbalances and inflationary pressures, a restrictive fiscal policy in Serbia is key to maintaining macroeconomic stability. Nonetheless, in a politically overheated environment ahead of early elections, the government opted for satisfying the electorate and thus to ease fiscal policy. An upward
revision of expenditures (wage hikes in the budgetary sector, payments of bonuses, early repayment of debt to pensioners) led to a cut in the budgeted surplus from 2.3% of GDP to 0.7% of GDP back in October.

Current account balance and FDI inflow
(1997-2009)



Source: NBS, UniCredit Group New Europe Research Network

But the adoption of this draft will largely be determined by the outcome of coalition negotiations and the shape of the new government. Small budget surpluses and early debt repayments should, however, enable public debt to decrease in the years ahead.

MOODY'S LT FC RATING	S&P's LT FC RATING	FITCH LT FC RATING	SPREAD (DEC) N.A.
Not available	BB-/Positive	BB-/Stable	EMBI+ Spread on Euro Curve

	2004	2005	2006f	2007f	2008f	2009f
Nominal GDP (€bn)	19.7	21.0	24.3	29.4	33.5	38.0
GDP (per capita, €)	2,618	2,792	3,231	3,908	4,445	5,050
Real GDP (% yoy)	8.4	6.2	5.7	6.0	6.3	6.5
Inflation (CPI) yoy, eop (%)	12.1	17.1	6.6	8.0	5.5	5.7
Inflation (CPI) yoy, avg (%)	11.4	16.2	12.7	6.6	6.4	5.9
Unemployment rate (%, avg)	18.5	20.8	20.9	21.0	19.8	19.3
Exchange rate/€, eop	78.9	85.5	79.0	78.0	77.5	75.5
Exchange rate/€, avg	72.6	83.2	84.16	78.6	77.9	76.5
2W repo rate, eop	24.0	19.8	14.0	10.0	8.0	7.0
2W repo rate, avg	26.0	21.0	17.0	12.0	9.0	7.5
Current account/GDP (%)	-11.6	-8.6	-11.5	-9.9	-9.7	-9.3
FDI/GDP (%)	3.9	5.9	13.9	6.6	6.8	5.9
Budget balance/GDP (%)	0.9	1.9	1.4	0.3	0.5	0.7
Poblic debt/GDP (%)	57.8	48.2	38.8	34.7	29.8	27.2
Total external debt/GDP (%)	57.5	59.2	61.7	63.7	63.8	64.8

BRIEF ECONOMIC OUTLOOK

Despite some political noise the economy is expected to show strong growth in the years ahead. Still it will not be in a position to exploit its full potential as structural reforms are slow and limited only to a few economic sectors. Bolstered by a strong national currency, price stability will be maintained. At the same time, external imbalances are to remain pronounced, with sustained strong import demand

countering the country's gradually increasing export potential. External financing needs will, however, to a great extent be met by strong foreign direct investment inflows. The creation of a business-friendly environment, ongoing EU integration and the overhaul of the legal, administrative and judicial system are necessary to secure sustained foreign direct investment inflow based on greenfield investments, once privatisation revenues dry up. Given strong capital inflows and ample foreign exchange reserves early debt repayments are expected to continue, further contributing to an improvement in Serbia's international debt position.

In 2007, we see private consumption picking up on monetary easing and a continued generous public wage policy. Last year's huge privatisation deals indicate stepped-up investment activity, especially in the telecom and banking sectors. But the higher momentum of investments will also be underpinned by the National Investment Plan with an estimated investment volume of some €1.7 billion, adopted by the government in the summer of 2006. The development of public consumption is, however, difficult to assess in light of the fact that no budget for 2007 was passed by the outgoing government ahead of parliamentary elections. Although exports are expected to grow robustly given gradually widening export capacities as a result of corporate restructuring, import propensity will rise on strengthening domestic demand and the anticipated further appreciation of the dinar, with the negative contribution of foreign trade to growth allowing only for a slight acceleration in growth to a real 6% in 2007, with some downside potential in case of a prolonged political paralysis.

Strong wage growth is expected to continue also in 2007, with the government's wage policy as one of the main risk factors in the context of disinflation. The government recently approved a 12.2% increase in the minimum net wage to RSD 9,570 to be applied in the first half of 2007.

Inflationary pressure also remained moderate at the beginning of 2007, allowing the NBS to cut the policy rate by an additional 100 basis points to 13% in January. Given a favourable inflationary outlook for the whole of 2007 of 6.6% on average (official target: 6% core inflation with a +/- 2% variation band) and the current large interest rate differential to euro rates, further rate cuts are to be expected in the coming months with a view to preventing speculative capital inflows and thus a further significant strengthening of the RSD, which in turn could undermine Serbia's external competitiveness.

The magnitude of FDI inflows in the next years will, however, largely depend on the pace of the formation of a new government, its longevity and finally its commitment toward structural reforms. Large-scale privatisations include a 37.5% stake in the national oil company NIS and the sale of Bor-based mining complex RTB. A novelty in FDI developments in 2007 will be a huge FDI outflow, as Serbia's state-owned Telekom Srbija in December 2006 acquired a 65% stake in Bosnia and Herzegovina's Serb entity's Telekom Srpska for €646 million.

Against the background of an anticipated sustained robust private consumption in the years ahead, driven by both expansionary fiscal and monetary policies and the high FDI-related import propensity in regard to capital goods, the current account deficit is expected to narrow only marginally in 2007-2009, despite widening export capacities as a result of corporate restructuring and regional trade cohesion due to CEFTA membership. The current account deficit is seen moving between 9-10% of GDP in the next few years.

Although the government's 2007 fiscal course is still unclear, given the fact that it has not adopted a budget for 2007 ahead of early elections, fiscal easing is expected to continue not only on the back of a lax public wage policy, but also due to higher public expenditures laid down in the National Investment Programme. The draft budget 2007 prepared in the autumn 2006, but not yet adopted by parliament, is based on GDP growth of 7% and inflation of up to 7.5% and calls for a target surplus of 0.5% of GDP.

FIC Recommendations

- Finalize the privatization process during 2007
- Continue with more vigour the corporate sector restructuring
- Maintain current efforts to bring down inflation
- Continue the policy of establishing the exchange rate on the basis of supply and demand of foreign exchange
- Control public spending and generate a fiscal surplus in the course of 2007

GENERAL

Chapter 1

THE NEW CONSTITUTION OF THE REPUBLIC OF SERBIA

The New Constitution of the Republic of Serbia was officially promulgated on 8 November, 2006, being previously adopted by the National Parliament and confirmed in a referendum. The most prominent new features are: more comprehensive regulation and protection of human and minority rights, transformation of the framework for general property rights, and creation of a more flexible mechanism for amending the Constitution.

The Constitution's preamble declares, inter alia, that the province of Kosovo and Metohia is an integral part of Serbia. The Constitution denotes the state as both national and civil, by accepting the mixed concept that Serbia is a state of the Serbian people and all its citizens. The state is based, inter alia, on the principles of civil democracy and commitment to European principles and values. The official alphabet is Cyrillic and the national anthem is Bože pravde.

The organizational structure of the governing offices and bodies preserves the previous semi-presidential system with a bi-cephalous executive branch and the two-fold decentralization of authority through local autonomy and local self-government. Denoting the status of the two autonomous provinces, the Constitution defines the status of Kosovo and Metohia as having "substantial autonomy".

The economic system is based on an open and free market economy, freedom of entrepreneurship, independence of business entities, and equality of private and other types of ownership. Social dialogue between labor unions and employers is designated as the means of attuning market economy and social and economic status of workers. It is guaranteed that the rights gained through capital investments may not be diminished by subsequent statutes.

Equipollence and equal protection of private, public (state) and cooperative property is proclaimed. Social property ceases to be a constitutional concept with the Constitution mandating its transformation into private property. The use and disposal of agricultural, forestry and privately-owned urban construction lands are free. By expressly providing for the possibility of privately-owned urban construction land, the new Constitution diverges substantially from the previous one, thus affirming the conceptual framework of the 2003 Law on Construction and Urban Planning.

Foreign and domestic individuals and entities receive equal treatment with respect to market competition. Foreign physical and legal entities are permitted real estate ownership rights (consistent with statutes or treaties). These physical and legal persons can also acquire concessions to exploit natural resources and assets of public interest.

The general principles of international law and ratified international agreements are an integral part of the domestic legal system with direct validity and applicability. Since ratified international agreements must comply with the Constitution, equipollence between the Constitution and general international legal principles can be inferred. Criminal prosecution and punishment for the execution of war crimes, genocide or crimes against humanity are not subject to a statute of limitations. Capital punishment is forbidden.

Notwithstanding the comparatively large number of norms pertaining to human and minority rights, the protection of these rights is reinforced also by the newly added authorization to the Constitutional Court to bring decisions on constitutional appeals that are filed against specific acts of public authorities who might deny or limit such rights. The Constitution also provides the Constitutional Court with new jurisdictional authority for cases involving constitutional issues related to or violations by the President of the Republic.

The 2006 Serbian Constitution formally and legally represents the culmination, from a legal perspective, of the political changes initiated in October 2000, thus creating the necessary legal conditions for the restructuring Serbia into a modern democratic community that is now positioned for integration with the European Union.

Chapter 2

BUSINESS REGISTRY AGENCY

Current Situation

During 2006, some novelties in the application of regulations and operations of the Agency for Business Registries occurred. The main activity of this Agency is to oversee and manage three centralized data bases: Registry of Commercial Entities, Registry of Charges on Rights and Movable Assets, and Registry of Financial Leasing.

Registry of Commercial Entities

The registration procedure functions quite efficiently. Once all necessary documents are submitted, the decision on registration is issued within the legal deadline of 5 working days. This is followed by the procedure to obtain a Tax Identification Number (PIB). The duration of this procedure depends on the efficiency of the local tax authority and the time period necessary for opening the company's bank account.

In 2006, the Agency undertook the registration of entrepreneurs and transferred the data on entrepreneurs from the registries maintained by the municipalities to the Registry of Commercial Entities.

Registry of Charges on Rights and Movable Assets

The Registry of Charges on Rights and Movable Assets became operational in 2005. This enables charging movable assets by registering the charge into the registry which, in turn, provides public data on the charge, establishes the order of priority between the creditors according to the moment of registration, and provides greater security for creditors.

Registry of Financial Leasing

This Registry continued to perform its functions in 2006.

Positive Developments

In 2006, the number of registered companies and entrepreneurs increased significantly. Additionally, a public debate was initiated over the adoption of the Law on Changes and amendments to the Company Law, which should clarify certain inaccuracies and resolve some deficiencies of the law noticed in practice.

The Registry of Charges and the Registry of Financial Leasing have significantly increased their operations. Having in mind that financial leasing and charging movable assets are very important mechanisms which facilitate lending at lower interest rates, we can expect that the operations of these two registries will result in lower interest rates and the expansion of lending in Serbia.

Remaining Issues

The registration process for commercial legal entities requires the opening of a bank account. The procedure for opening a bank account is now subject to provisions of the new Money Laundering Prevention Act. The Act does not foresee, however, any difference in requirements when the bank account applicant is a company listed (quoted or public) on a stock exchange in another country. Additionally, banks are required to obtain information on the shareholders of these companies down to the level of the natural person (for shareholders that account for more than 10% in the company). The process becomes very cumbersome if it involves publicly quoted international companies that have a large number of shareholders, some of which are Investment or hedge funds which, in turn, are not subject to regulatory constraints regarding their shareholders. As a result, the company incorporation procedure is lengthened significantly due to the requirements related to the bank account opening process, imposing in practice an unnecessary administrative barrier to foreign investment in Serbia.

FIC recommendations

- Initiation of a discussion with the Ministry of Finance to establish a less rigid interpretation of the Money Laundering Prevention Act, at least for investors who are publicly quoted companies on stock exchanges.
- Establish direct cooperation between the Registry of Commercial Entities and the Tax Authority that would enable issuance of the Tax Identification Number during the company registration procedure rather than a subsequent separate procedure. This would resolve a conflict with the Law on Registration of Commercial Entities. This law states that the PIB is to be submitted with the company registration documents. In fact, this is currently done after the registration procedure but before the company is entered into the Registry by submitting a request for changing the company information in the Registry. Direct coordination with the Tax Authority should be based on the model of cooperation already existing with the Serbian Statistical Bureau. The Bureau provides the Agency with unique company registration numbers that are issued during the company registration procedure.
- FIC participate in the drafting of the Law on Changes and amendments to the Company Law.

Chapter 3

SECURITIES MARKET TRENDS

THE LAW ON THE MARKET OF SECURITIES AND OTHER FINANCIAL MARKETS

Current Situation

The new Law on the Market of Securities and Other Financial Markets (Official Gazette 47\2006) was enforced on 10 June 2006 but did not become applicable until six months later on 11 December 2006.

The Law regulates circumstances governing the organized market, the issuance of securities, participation in the organized market and the activity of the Security Exchange Commission (SEC) and the Central Registry, Depository and Clearing of Securities.

Positive Developments

- The Law defines a "qualified participation" as:
  - direct or indirect participant
  - owning shares with voting rights
  - performing other managing rights
  - participating in the capital of another legal entity with at least 5% of the subject legal entity capital

  Acquiring qualified participation is subject to preliminary approval of the SEC.

- Securities, issued until the enforcement date of this Law, or within six months following its enforcement, should be dematerialized (i.e. transferred and registered in the electronic form);
- Concept of privileged information, as well as other principles of the Law, are stipulated in a more comprehensive manner in order to comply with EU directives;
- The simplified procedure for short-term securities issuance is aimed at less than 100 legal and/or natural persons and does not include public invitation or other forms of public announcement.

Remaining Issues

- Lack of experience regarding implementation of the Law due to the fact that it became applicable only since December 2006;
- Lack of experience in the sense of complementary application with the recently adopted Law on the Takeover of the Joint Stock Companies;
- Definition of Initial Public Offer/Secondary Public Offer (SPO) does not setforth an SPO concept that leads to market development - i.e. to permit the simultaneous conduct of both a public offer of a new issue together with an offer of previously issued shares within the same prospectus;

- Provision that forces brokerage companies to refuse purchase orders when it is concluded that there are insufficient funds in a client's account to settle the liabilities upon execution of the purchase order;
- Book building process, which goes hand in hand with IPO/SPO process, is hard to implement. The Companies Law prescribes the price of the new share issue (articles 240. and 445.);
- Tariffs. Compared with other markets (Bulgaria, Croatia, Slovakia, Poland, etc.), tariffs are higher for issuers in Serbia;
- Article 165 is a setback for the implementation of netting principle.

FIC Recommendations

- The Law should be more clear on the issue of qualified participation;
- Pass remaining by-laws needed for implementation of the Law;
- Amend the Law in a way that would allow joint public offers of new issues and existing shares;
- Issue an opinion or amend the Law so that other types of transaction coverage (credit facilities, margin accounts, securities, etc.) are taken into account;
- Price of a new share issue shouldn't be defined by the Companies Law;
- Reduce tariffs for issuers and implement a cap structure for fees implied on the nominal value of the issue;
- Netting of cash and securities positions in the trading process should be allowed.

THE LAW ON TAKEOVER OF JOINT STOCK COMPANIES

Current Situation

In May 2006, the Serbian Parliament adopted the new Law on Takeover of Joint Stock Companies ("Takeover Law"). The Law entered into force on June 10, 2006, derogating the provisions from the previous Law on Market of Securities and Other Financial Markets regulating a takeover bid (TOB).

Positive Developments

The Takeover Law regulates the TOB more thoroughly than it was previously regulated. The Takeover Law aims to provide comprehensive regulation, to protect minority shareholders of a target company and to create a level playing field for participants in a TOB.

Furthermore, the price, as one of the most important elements of the bid, is set out in accordance with market principles. The minimum offered price in a TOB equals the weighted average price of shares of the target company within three months before the publication of the notice of intention, determined on the basis of the reports on trade on the stock exchange.

To avoid price manipulations during a TOB process, the Bidder is required to pay for the shares of the target company at their last actual market price.

The Takeover Law introduces new rules regarding TOBs of open joint stock companies, the conditions and the procedure of TOBs, rights and obligations of participants in the process and supervision over the process by competent authorities, all in compliance with the European Union (EU) criteria standards.

The key principles of the Takeover Law are the following:

- Target entity's shareholders have an equal position to the bidding party;
- Both minority and majority shareholders have rights in the TOB process;
- Management of the target entity acts in the best interest of the shareholders;
- Accurate, full and timely information must be submitted to the target entity's shareholders;
- TOB procedure must be performed as quickly as possible;

- Market disturbance that results in a significant increase or decrease in the price of the target entity's shares is prohibited.

The Takeover Law applies to any takeover of joint stock companies (JSC) having a registered office on the territory of the Republic of Serbia, provided that shares issued by such a company are traded on the Belgrade Stock Exchange (BSE), the only stock exchange in Serbia.

The takeover procedure is performed through the TOB as a public bid addressed to all shareholders of the target entity for the purchase of voting shares. The subject of the TOB may only be those companies whose shares have been traded on the BSE for a period of at least last three months prior to the publication of the notice of intent to takeover.

A launched TOB must be open for at least 21 days and may be open for 45 days at the most. The TOB is deemed open from the date of publication of the TOB in a daily newspaper. In case a launched TOB is changed, it remains open for an additional 7 days. In no event may a TOB be open for more than 60 days, except in the case of publication of competitive TOB's.

The SEC approves the TOB within two business days from the day of submission of the request and informs the Central Securities Depository and Brokerage House on the TOB launched.

Remaining Issues

The application of TOB rules as stipulated in the Takeover Law is limited by a number of exceptions, which among others are:

- Acquisition of shares of a bankruptcy debtor in a bankruptcy procedure;
- Acquisition of the target company shares through a merger of companies if only one participant in the merger procedure already holds shares of the target company;
- Acquisition of shares through the change of legal form of a company;
- Trade with shares transferred to the Share Fund through privatization and trade with shares offered as a package with the Share Fund's shares;
- Trade with shares held by the Republic of Serbia, Pension and Disability Fund or Development Fund of the Republic of Serbia;
- Trade with shares issued by commercial banks or insurance companies, whose legal and beneficial owner authorizes the Agency for Deposit Insurance to sell shares on his behalf and for his account;
- In other cases stipulated by the Law;
- Law is very restrictive vis-à-vis terms. The bidder has to submit a request to the SEC for approval of a take over bid one day after the announcement of the intention to perform a take over;
- Law does not regulate who is the beneficiary of the guarantee in a take over bid;
- Competing take over bid and approval of the Competition Protection Commission (CPC), in cases where the bidder's take over would lead to concentration.

FIC Recommendations

- The number of exceptions stipulated in the Takeover Law should be narrowed down in order to broaden its area of application;
- To allow 5 working days for the submission of TOB documents to the SEC after the announcement of the intention for take over;
- The Law should stipulate that the bidder has to place an irrevocable first call bank guarantee on behalf of shareholders who will deposit their shares, for an amount sufficient for the payment of all shares referred to as the subject of the takeover bid;
- Competing take over bid should not be linked to the CPC approval for conducting the concentration.

THE INVESTMENT FUNDS LAW

Current Situation

After over four years in the pipeline, the Investment Funds Law was added to Serbia's regulatory framework for financial markets. The law and the implementing regulations, passed by the SEC, became effective in December 2006. The law conforms to the concepts outlined in the EU's UCITS directives, even exceeding the rudimentary level of the local capital markets.

The law regulates the entire backbone of collective investment – management companies, funds (open-end, closed-end, and private), and custodians (depositary banks) – and sets forth the supervisory and regulatory role of the SEC for this segment of the financial markets.

Fund management companies stand as cornerstones of the system, licensed and regulated by the SEC, with fund management as their sole activity. The minimum capital requirement is €200,000. Fund managers have a fiduciary duty to the fund's investors and are subject to ample disclosure requirements. Additionally, the management companies are required to employ one SEC-licensed portfolio manager per each fund managed.

Open-end and closed-end funds creation, registration, prospectus-based marketing, Net Asset Value reporting, and disclosure requirements are fairly standard, fitting to the retail investors' base. Such funds are formed by the management companies, with a threshold of assets collected set at €200,000. Their investment strategies, set in each fund's prospectus, must be within the strict limits of the law, both in terms of assets they can invest in and exposure to a single asset class or issuer.

Custodian operations serve as an additional safeguard for fund investors, by having an independent corrective and controlling role in the manager–investors–SEC triangle. Custodians may not be a related party to the management company.

Private funds, as defined in this law, represent specific institutions, structured as limited liability companies, that aim to attract investments from a wealthier and more sophisticated target group. No restrictions exist as to the qualification of investors, whilst the threshold for a single investor is €50,000. Although free from any limits on investments and exempt from reporting/disclosure requirements and mandatory operations through custodians, private funds also are required to be managed by licensed management companies and registered with the SEC.

Positive Developments

- Valuable addition to the financial services framework;
- Mostly standardized provisions, in line with the regional and European norms.

Remaining Issues

- Requirement of one licensed portfolio manager per each fund is a major imperfection -- it created an artificial demand for a non-existing profession, entailing significant costs of finding, hiring, and training adequate license-holders;
- High costs of trading in the Serbian capital markets (including unfavorable taxation of capital markets transactions);
- Lack of clarity on "short positions" ban language – provision that open-end funds cannot "take short positions";
- Treatment of foreign management companies and funds;
- Prospectus: the Law prescribes that a fund must present in the prospectus any asset which accounts for more that 1% of the fund;
- One member can't hold more than 10% of the total net asset value of the fund.

FIC Recommendations

- Remove the requirement of having one licensed portfolio manager per each fund;
- Change the SEC regulation requiring management companies to have both an internal auditor and an internal controller on their payroll;
- Lower the tax burden on investment funds as part of the general effort to boost the financial markets through a major overhaul of the applicable taxation regime;
- Clarify (in applicable SEC statutory instruments) the activities of custodians;
- Introduce a specific, more tailor-made approach to regulation of private funds' management companies – should differ from management companies of open-end and close-end funds;
- Consider removing restriction that one member can't hold more than 10% of the total net asset value of the fund as well as to abolish obligation to present any asset in the prospectus which participates with more than 1% of the fund. This is not the practice in the investment fund industry.

Chapter 4

THE COMPETITION PROTECTION LAW

Current Situation

The Competition Protection Law (CPL) became effective on 24 September 2005.
As a general matter, the CPL regulates the following: (1) control over all or a part of one or more enterprises acquired by another enterprise; (2) where there is an agreement between parties that would materially prevent, restrict or distort competition on the Serbian market; and/or, (3) where there is abuse of a dominant position on the market.
The Commission for the Protection of Competition, established in April 2006, is responsible for reviewing all submissions required to be made under the CPL and for issuing approvals.

(1) Merger Control:

When a market participant acquires direct or indirect control of another market participant it is deemed a "concentration". If certain thresholds are met, then a filing for merger clearance is mandatory. The thresholds that trigger a filing requirement are:

- if the combined total annual turnover of the companies involved in a concentration on the market of the Republic of Serbia exceeds the RSD equivalent of €10 million; or
- if the combined total annual worldwide turnover of all concentration participants in the prior financial year exceeds the RSD equivalent of €50 million and at least one of the enterprises involved in the merger is registered on the territory of Serbia.

A market participant acquiring control must file a clearance request with the Commission within a period of 7 days upon the later of the date of the signing of the relevant concentration agreement (e.g. a share purchase agreement), the announcement of a public takeover bid, or the date on which control is acquired.

(2) Prohibited Agreements:

The CPL names certain types of anti-competitive agreements that are deemed null and void. These include agreements that: (a) directly or indirectly fix purchase or sales pricing or other trading conditions; (b) limit or control production, the market, technical development or investment; (c) share market or sources of supply; (d) apply dissimilar conditions to equivalent transactions with other undertakings thereby, placing them at a competitive disadvantage; and/or (e) make the conclusion of contracts subject to acceptance of supplementary obligations, which by their nature and commercial usage have no connection with the subject of the contract.

Such prohibited agreements can be "horizontal" or "vertical": (a) "horizontal" being agreements among existing and potential undertakings operating on the same production or supply level; and, (b) "vertical" being those among existing and/or potential undertakings not operating on the same production or supply level.

The parties to an agreement must file an application to the Commission within 15 days from the date of the signing of any agreement that could be exempted from prohibition.

(3) Abuse of Dominant Market Position:

Abuse of a dominant market position is prohibited, and an undertaking is deemed to have a "dominant market position" if: (a) the enterprise has a market share of more than 40% of the "relevant market"; or (b) two or more enterprises have a combined market share of more than 50% of the relevant market.

"Abuse of a dominant market position" includes practices that restrict, distort or prevent competition, such as: (i) directly or indirectly imposing unreasonable purchase or sales pricing, or other unreasonable conditions; (ii) limiting production, markets, or technical development, thus causing harm to consumers; (iii) applying dissimilar conditions to identical transactions with other trading parties, thereby placing them at a competitive market disadvantage; and/or, (iv) making contracts subject to acceptance by other parties of supplementary obligations that (by their nature or according to commercial custom) have no connection with the subject of such contracts.

Consequences for Failure to File:

An enterprise may be fined by an amount equal to 1% to 3% of its total annual revenues for the prior financial year, if it: (a) fails to notify to the Commission an agreement which may be exempted from prohibition (note that if the agreement is indeed a "prohibited agreement", then it would be null and void and the parties would face a fine of 1% to 10% of total annual revenue); or (b) fails to act in accordance with a request made by the Commission for information or provides incorrect, incomplete or false information. The responsible person of the legal entity that committed the infringement may also be fined. The time limit for prosecution of infringements is 5 years from the date of the infringement.

Positive Developments

The Commission is generally cooperative and has shown a reasonably high level of expertise in processing approval applications.

Recently, the official web site of the Commission became operational and some of the opinions issued by the Commission are now available on their website.

FIC Recommendations

- "Block exemptions" have still not been introduced to exempt certain categories of agreements from having to seek clearance;
- The mandatory notification thresholds should be higher, and only a Serbian presence should trigger a filing requirement;
- The Commission's website should be upgraded to provide an official database for the criteria of defining the relevant product market and the relevant geographic market.

Chapter 5

INTELLECTUAL PROPERTY

Current Situation

After the dissolution of the State Union of Serbia and Montenegro in May 2006, all regulations in the area of intellectual property were transferred to Serbia. This change has not affected the legal protection of intellectual property. The competent institution for intellectual property issues is the Intellectual Property Agency, with its registered seat in Belgrade.

The following intellectual property rights are regulated and protected: patents, designs (former samples and models), trademarks, indications of geographical origin, topographies of integrated circuits, copyright and related rights. All these rights are protected by special laws, adopted in 2004, except the Law on Indications of Geographical Origin, which was adopted in 2006. The Law on Protection of Herbal Sorts and the Law on Protection of Undiscovered Data is currently in the legal pipeline.

Positive Developments

In June 2006, the Law on Special Authorizations for Efficient Protection of Intellectual Property Rights was adopted. The essence of this Law is in accepting the contents of those clauses of TRIPs and the EU Directive that address the introduction of administrative-legal measures which ensure the efficient implementation of new, higher standards of IPR protection.

Since the implementation of the regulations on IP protection has a criminal-legal aspect, the protection provided by the Criminal Code, which came into force on 1st of January 2006, is very important. The Criminal Code now contains a special chapter (section) for offences against intellectual property.

Other significant improvements have been made. Natural and legal persons (foreign and domestic) enjoy three types of legal protection that are consistent with EU law: civil-legal protection in front of commercial courts or courts having general jurisdiction; administrative-legal protection through inspection bodies, customs and others; and, criminal-legal protection in front of criminal jurisdictional bodies.

The quality of jurisdictional protection has been improved by creating special departments in the district courts that are competent and have specialized knowledge/experience in intellectual property cases.

With respect to intellectual property rights, the foreign investors are infinitely better positioned today than a few years ago.

Remaining Issues

The adoption of the remaining two legal texts, on herbal sorts and protection of undiscovered data, is needed as soon as possible to complete the full set of laws in the IP area

FIC Recommendations

- The efficient and prompt execution of the Law on Special Authorizations for Efficient Protection of Intellectual Property Rights from 2006 should be conducted through the reorganization of existing inspection department and foundation of new ones as needed;
- The customs offices should be prepared to undertake new tasks as directed by law. There should be established a high level of communication between administration offices and bodies of inspection supervision;
- Undertake measures to communicate clear messages and alter the collective opinion so that people understand that IP piracy and forgery are not only unacceptable but not permissible. Reinforce this message and position through the actively prosecution and punishment of violators.

Chapter 6

THE LABOUR LAW

Current Situation

The current law was adopted in March and amended in July 2005. It has been the subject of serious criticism both by employers and employees. Another series of amendments may be expected during 2007. Because this law is considered particularly important and vital for attracting and maintaining foreign investments, FIC has a number of suggestions on how to improve the situation.

Positive Developments

In dealing with unemployment issues, apart from the Labour Law, Serbia has started applying the National Employment Strategy for 2005-2010 along with the National Plan of Employment Activities for the period of 2006-2008. The objective is to decrease unemployment and to support new employment.

Remaining Issues

- The new Labour Law unnecessarily imposes an obligation on the employer to respect a notice period of five workdays in canceling an employment contract during a trial period;
- Temporary employment for foreigners, limited to one year, has proven to be especially problematic since in practice this period has proven to be insufficient;
- Pursuant to the new law, the calculation of salary is more complex than the previous calculation. The Labour Law unnecessarily defines two salary levels, as bonus (Article 105, Paragraph 1) and as performance at work (Article 107, Paragraph 2) - bonuses are in their nature a reward for realized work performance;
- The Law unnecessarily burdens the employer with the obligation to pay special benefits to the employee for the compensation of food expenses, holiday compensation and work experience. This form of reward or special benefits has no relation to the employee's work performance. This could result in a counter effect whereby the employer can manipulate other components of the salary, especially the basic one which can be reduced to the minimum, particularly as the law obliges the employer to these payments as of 01/01/2006 without stipulating terms or minimum amounts. Further, the special listing of these payment categories, as well as special payroll lists, additionally complicate the procedure;
- According to the current provisions of the Labour Law, the employer's claim against the employee can be withheld from the salary only after obtaining a court's decision, in cases previewed by the Law or with the employee's consent. This makes it impossible for the employer to realize small claims without acquiring first the employee's consent in order to avoid initiating an unnecessary and costly legal procedure;
- The employment contract termination procedure is more complicated in the new Labour Law than in the previous one. The employer is obliged to warn the employee, in writing, the reasons for canceling the employment contract and to provide a period of at least five workdays (from the date that the warning was presented) within which the employee may respond to the written warning;
- An employee whose employment contract is cancelled due to unsatisfactory work performance and/or lack of required knowledge/abilities shall have the right to remain employed for a minimum pe-

riod of 30 days up to a maximum of 3 months (hereinafter: dismissal period), depending on the total number of years of being insured;
- Employer is required to permit the employee to use the first part of annual leave in time blocks of at least three working weeks;
- Employer is obliged to issue a decision regarding annual leave decision at least 15 days prior to date the requested annual leave would begin.

FIC Recommendations

- We believe that additional decreases in labor expenses are necessary in order to boost the employment rate and cut-down on so-called "moonlighting." This can be accomplished through either further reductions of the income tax rate and the income amount exempt from taxation, or by a reduction in social security contributions;
- The Labour Law should be amended to enable the establishment of temporary employment agencies that would be supervised by the Ministry of Labour. The agencies would act in an intermediary role, identifying work opportunities with the so-called service users (especially security services, child care, hygiene);
- Extend temporary work permit time limits to 3 years. The changes in the area of employment for foreign citizens must create a positive environment for foreign investments. It is necessary to ensure the greatest possible operational freedom for foreign citizens who invest into the local economy;
- The procedure of issuing working permits must be accelerated;
- Essentially, the distinction between bonus and performance at work does not exist; therefore, it is proposed that the Law be amended and the salary calculation be simplified;
- We propose that the above listed compensations (in the remaining issues section) be treated as discretionary possibilities for employers rather than required obligations;
- We suggest that the relevant article with respect to employer claims against employees be amended to state:

> the employer's claim against the employee could be withheld from the salary only based on a court's decision, in cases previewed by the law ***or the general act of the employer***, or with the employee's consent;

- Given the nature of a trial period, particularly in cases where the trial period is for a shorter time, we propose that the notice period during the trial period be reduced to 24 hours;
- We propose that the contract termination procedure be simplified and the obligation eliminated for the employer to provide 5 workdays to the employee to respond to an employer's written warning. The dismissal period should be not be longer than 15 days;
- Amend the law so as to provide that the usage of outstanding annual leave should be mutually agreed upon between the employer and the employee;
- Amend the law to reduce the deadline for issuing the annual leave decision to 5 days prior to the commencement of annual leave. In dynamic, fast-changing work environments, such as foreign investment companies, annual leave is often agreed upon on short notice, especially when it comes to management.

Chapter 7

DRAFT FOREIGN INVESTMENT LAW

Current Situation

A new draft Law on Foreign Investments was adopted by the Government in the autumn of 2006 with the aim to replace the existing Foreign Investment Law.

Due to Parliament's dissolution and a round of new elections in the meantime, the draft law was not acted upon by Parliament. This situation offers yet another opportunity for the Foreign Investors Council to suggest further amendments to the pending draft law and, thus, help the country to attract more foreign investment. Since by definition foreign investment is of primary interest to the Council, the comments and suggestions may be more detailed here in comparison to other sections of the White Book.

Positive Developments

- Articles 1-17 of the Law on Foreign Investments (hereinafter "LOFI") follow the general pattern of investment laws and are therefore, basically acceptable, but with certain corrections to be mentioned later;
- Article 18 on environmental protection is a novel feature recommended to be included in foreign investment laws, and therefore, welcomed. The article simply reiterates the old principle that a foreign investor is required to comply with Serbian environmental laws;
- Generally, the notion of a one-stop-shop could be an improvement over the existing situation, again with some caveats.

Remaining Issues

- The definition of a "foreign investor" should be broad enough to cover any kind of commercial entity, natural persons, joint ventures, business organizations, etc. Thus, the enumeration set forth under this definition should be illustrative rather than exclusive. The same is true for the definition of "foreign investment" which should be broad enough to encompass the multitude of ways in which an investor enters foreign markets and the assets that are considered to be an investment;
- While it is a welcomed development to have a one-stop-shop for qualified foreign investment, the following question is posed: Why would this facility handle only foreign investment and not Serbian (domestic) investment as well?
- Given that the one-stop-shop will be organized at the municipal level (except for major foreign investors), it might happen that implementation by the municipalities could be carried out in different ways, entailing different enacting legislation by the various municipalities.

FIC Recommendations

- The provisions regarding the one-stop-shop can be more effective by creating a single office at each trade register office where representatives of all the authorities, which are responsible for issuing the requisite permits in order for newly established businesses to become operational, are physically present. Typically, permits can be obtained by a simple declaration (in lieu of an oath) made by the

applicant, thereby avoiding paperwork and saving time. The accuracy of the declarations is then verified by the authorities through periodic controls;

- The definition of Foreign Investment (Articles 2 and 3) should be clarified in relation to: (A) Serbian holding companies (i.e., investments in Serbia carried out by a company that is in turn owned by a Serbian company); and, (B) Bilateral Investment Treaties (BITs) to which Serbia is a party, as in many instances BITs recognize investments through a number of layers of holding companies that involve countries where BITs exist and other countries where no BITs exist. It should be made clear that in relation to (A) the LOFI looks at the (direct or indirect) foreign shareholder of the Serbian holding company and grants the protections of the LOFI. In relation to (B), it should be made clear that the investor may choose to invoke either the protection afforded under the BIT or possibly the LOFI;
- In Article 2, the term "foreign" should be defined. Under the ICSID Convention, "national of another Contracting State" means: (i) a natural person that has the nationality of another state (which is a contracting state to the Convention) – double citizenship of a state party to the dispute is grounds for objection to the ICSID Centre's jurisdiction; and, (ii) a legal person which has the nationality of a contracting state other than the contracting state party to the dispute;
- In Article 3 (3), we suggest that the wording "any other property right (ownership, intellectual property rights, and the like) in the Republic of Serbia" be replaced by "movable and immovable property and any other property rights such as mortgages, liens or pledges, including intellectual property rights";
- Furthermore, with respect to Article 3, we suggest that the following be inserted*:*

  "(4) claims to money or any performance under contracts having financial value
  A change in the form of the investment does not affect its character as investment";
- Article 4 should mention that this protection also relates to securities (shares, bonds, other instruments) of a Serbian issuer traded on a stock exchange, in any event irrespective of the size of the shareholding;
- Article 6 should explicitly mention security interests (pledges, mortgages, etc.) granted to Investors;
- Article 7 is limited only to investments in commercial companies, whereas Article 3 and the following are wider;
- Article 9 should include some provisions regarding the treatment of possible (future) restitution claims on property acquired by a foreign investor;
- We suggest adding more substance to Article 17 by granting additional incentives such as customs exemptions, tax breaks, subsidized financing, etc. for investments that: (A) go beyond what current applicable environmental laws require; or (B) contribute to the remediation and clean-up of areas already affected by pollution. This would also present a good opportunity to encourage and to foster investments into existing industrial sites (brown-field investments), thereby helping the Serbian government to avoid assuming contingent environmental liabilities;
- For Article 17 we suggest the following wording:

  "(1) For the purpose of this Law, an investment dispute is a dispute between an investor, as defined under this Law, and Serbian state, its authorities, representatives or similar, arising out of or related to (a) an investment, as defined under this Law; or (b) an alleged breach of any right conferred or created by this Law or applicable Serbian law, with respect to an investment or investor.

  (2) In the event of an investment dispute, the parties to the dispute should try to seek the settlement of the dispute through consultations or negotiations. If the investment dispute cannot be settled amicably, the parties may choose to submit their dispute to:

  (a) the courts or administrative courts or bodies; or

  (b) the International Centre for the Settlement of Investment Disputes (the "Centre") established by the Convention on the Settlement of Investment disputes between States and Nationals of other States, Washington ("ICSID Convention"), provided that the investor's state is contracting party to the ICSID Convention; or

  (c) the Additional Facility of the Centre, if the Centre is not available; or

  (d) the ad-hoc arbitration under the Arbitration Rules of the United Nations Commission on International Trade Law ("UNCITRAL"); or

(e) any other arbitration institution, or in accordance with any other arbitration rules as agreed between the parties or provided under treaties or international agreements.

(3) The parties to the investment dispute consent to satisfy the requirement for:

(a) "consent in writing" for the purposes of the ICSID Convention and Additional facility Rules;

(b) an "agreement in writing" for the purposes of the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, New York 1958.

(4) Any arbitral award rendered pursuant to Article 17 of this Law shall be final and binding on the parties to the investment dispute";

- Article 20
  Pursuant to this article, a foreign investor can acquire immovable property in accordance with the law regulating property relations. Taking into account what is prescribed by the referenced law (Article 82b of the Law on the Basis of Property Law-Elevations); the acquisition of real property by foreigners is subject to the condition of reciprocity where a foreign investor must prove the existence of reciprocity between its country and Serbia. From our experience, proving that reciprocity exists is a very complex procedure before the relevant Serbian authorities.

Chapter 8

THE LAW ON FOREIGN EXCHANGE OPERATIONS

Current Situation

The new Law took effect on 26 July 2006. There is the clear intent to harmonize this law with the Law on Banks, the Law on Securities and Other Financial Instruments, and the Law on Foreign Trade.

The current regime allows for a longer receivable period for export proceeds of up to 180 days (previously 90 days). Resident legal entities can trade (buy and sell) assets or liabilities arising out of the export business operations of other resident legal entities. Furthermore, on capital transactions, residents are permitted to invest in real estate outside Serbia and non-residents in Serbia under certain conditions. Residents (both physical and legal persons) may invest in securities abroad to the extent that the investment is not considered "direct investment," as long as the securities are issued in OECD member countries and by international financial institutions. The National Bank of Serbia maintains the right to prescribe the terms and conditions under which such investments are allowed.

Non-residents are allowed to borrow in RSD on terms and conditions that are to be defined by the NBS in a separate by-law (to be issued).

Non-resident transfers abroad are also regulated, with the repatriation of proceeds allowed freely once tax liabilities to Serbia have been settled (a tax certificate issued by the Tax Authority).

Positive Developments

- There has been liberalization of foreign exchange and capital transactions in Serbia;
- Introduction of financial derivatives on the Serbian market.

Remaining Issues

The lack of the issuance of all necessary by-laws by the National Bank of Serbia renders some dimensions of the new Law on Foreign Exchange Operations as practically in-operative. Therefore, all such by-laws need to be issued to establish clear and consistent rules.

FIC Recommendations

The by-laws to be issued should be concise and with minimal administrative and documentation requirements, especially as it concerns movement of capital. A liberal stance, in the opinion of FIC, will induce higher capital flows and a balanced risk profile for local investors, while at the same time will fuel capital flows for investment purposes into Serbia.

Chapter 9

TAX

I. DIRECT TAXES

A. Taxation of Corporations

Current Situation

Taxation of corporations is governed by the Law on Corporate Income Tax (*Official Gazette of the Republic of Serbia*, No. 25/2001…84/2004; the "CIT Law"). The CIT Law is supplemented by a number of by-laws regulating in detail the implementation of legislative provisions.

Taxable Persons
Persons subject to corporate income tax are cooperatives and legal persons which generate profit through the sale of goods and services, irrespectively of the form in which they are organized.

The scope of tax liability is different depending on whether a taxable person is a resident of Serbia or not. For corporate income tax purposes, a resident is a legal person incorporated under the laws of Serbia or a person whose real seat is situated on the territory of Serbia. Serbian residents are liable to pay corporate income tax on their global income while non-residents are liable to pay tax only on the profit generated through the activities of their permanent establishments situated on the territory of Serbia.

Tax Rate
Corporate income tax is levied at the flat 10% tax rate.

Tax Base
Taxable income is derived from the taxpayer's profit stated in the taxpayer's financial statements, prepared in accordance with IFS, and adjusted for tax deductible and non-deductible items, in accordance with the CIT Law.

Generally, an expense is deductible for tax purposes if it meets general tax deductibility requirements prescribed by the CIT Law: the expense was actually incurred by the taxpayer, the expense was made for business purposes, and is sufficiently and properly documented by the taxpayer. Other limitations on deductibility of expenses may be divided in two major groups:

a) Non-deductible expenses:
- contributions to political organizations;
- interest for the late payment of tax;
- fines and penalties;
- gifts made to related parties;
- share in profits paid to employees and other persons;
- calculated and unpaid severance pay to retired employees and other payments made to employees in relation to termination of employment;
- provisions for receivables are recognized only if the receivable is overdue by at least 60 days;

- write-offs of receivables are recognized only if the taxpayer unsuccessfully attempted to settle the receivable in the court proceedings;
- long-term reserves are recognized only if made for the reproduction of natural resources, guarantees, deposits, and other securities;
- impairment losses;
- inventory expenses are recognized in the amount calculated under the average price method or FIFO method.

b) Partially deductible expenses:

- expenses made for cultural, educational, scientific, humanitarian, religious, environmental, and sports purposes: deductible up to 3.5% of taxpayer's total revenues;
- expenses for cultural purposes: deductible up to 1.5% of taxpayer's total revenues;
- membership fees: deductible up to 0.1% of taxpayer's total revenues;
- advertising, promotional expenses and business entertainment: deductible up to 3% of taxpayer's total revenues.

Tax Depreciation

Tax depreciation is applied to assets with a useful life exceeding one year and with a purchase price higher than one average gross salary in Serbia at the time of the purchase. The rate of depreciation depends on the depreciation group in which the asset is classified, ranging from 2.5% to 30%. Assets classified in group 1 are depreciated individually, under the proportional method. All other assets are depreciated under the declining method, applied on the total value of assets included in the given depreciation group.

Transfer-Pricing

Taxpayers are required to disclose in their annual tax return expenses and revenues incurred in transactions with related parties. Taxpayers are required to specify the value of their related-party transactions at transfer-prices and at "arm's length" prices, and adjust their taxable income for the amount of the difference. For purposes of determining arm's length prices, taxpayers should use the comparable uncontrolled prices method or, if this method cannot be used, the resale-price method or the cost-plus method.

Thin Capitalization

Interest charged on loans between related parties is recognized as a tax deductible expense only up to the amount of four times the taxpayer's registered capital multiplied by 110% of the interest rate charged by the national bank of the country in whose currency the loan is denominated as of December 31st. The excess of interest not deductible in the given year may be carried forward in the following year, subject to the same general limitations.

Tax-loss Carry Forwards

Losses incurred in a given tax year may be carried-forward and offset against taxable income in the following ten years.

Tax Consolidation

Tax consolidation is allowed under the condition that all members of the consolidated group are residents of Serbia and that one member of the group controls, directly or indirectly, at least 75% of the shares in other member companies. Members of the consolidated group are liable to pay tax proportionally to the participation of their taxable profit in the total profit of the group. Once the group makes the election for the tax consolidation, consolidation must be applied for at least 5 years.

Capital Gains

Capital gains incurred from the sale of immoveable property, copyrights, shares, and other securities are taxed separately at the general 10% tax rate. Capital gains may be offset against capital losses. Capital losses not utilized in the given tax year may be carried forward and offset against capital gains in the following years, but for not more than ten years.

Withholding Tax

Payments of dividends, interest, royalties, capital gains and fees for the rent of moveable and immoveable property paid by a resident taxpayer to a non-resident entity abroad are subject to the withhold-

ing tax of 20%. The applicable withholding tax rate may be lower if the income is paid to a country with which Serbia has concluded a double taxation treaty.

Tax Incentives
The CIT Law provides numerous incentives aimed at attracting new investment, development of new technologies, stimulating employment, and development of underdeveloped regions in Serbia:

a) Tax Credit for Investment in Fixed Assets
Taxpayers who acquire new assets for purposes of conducting their registered business activities are entitled to a tax credit in the amount equal to 20% of the value of the investment, but not more than 50% of the total tax due in the year in which the investment was made. The amount of tax credit not utilized in the current year may be carried forward for the next 10 years.

In addition, the taxpayers who invest, over any given period of time, more than RSD 600 million in their fixed assets (including investment in fixed assets by a taxpayer's shareholders) and who employ more than 100 employees, are exempt from the payment of tax for a period of 10 years, proportionally to the value of the investment.

b) Tax Credit for Hiring of New Employees
Taxpayers who hire new employees for an indefinite period of time are entitled to a tax credit in the amount of 100% of new employees' gross annual salary. The tax credit cannot be carried forward, and may be utilized only in the year in which the new employees were hired by the taxpayer.

c) Tax Credits for Investment in Underdeveloped Regions
A taxpayer who establishes a business unit in an underdeveloped region of Serbia is entitled to a tax exemption in the amount proportional to the participation of profits generated in the underdeveloped region in the taxpayer's total profits. In addition, a taxpayer who conducts business operations in regions with the status of a region of special interest for the Republic of Serbia is exempt from the obligation to pay tax for a period of five years, subject to the condition that a minimum of RSD 6 million is invested in fixed assets, at least 80% of which is used in the area of special interest, and that at least five new employees living in the area of special interest are employed.

d) Accelerated Depreciation
The CIT Law allows accelerated depreciation of assets used for environmental protection, scientific research, education, and professional improvement of employees. These assets may be depreciated at rates up to 25% higher then those prescribed under the CIT law for other assets.

Avoidance of Double Taxation
Dividends paid by resident entities to resident taxpayers are not included in their taxable income. For income generated by resident taxpayers abroad, the CIT Law provides a tax credit in the amount of tax paid abroad, but not more then the amount of tax which would have been paid on that income under Serbian laws.

Assessment and Payment of Tax
Serbian taxpayers are required to file their annual income tax return with the Serbian Tax Authority by March 10th of the current year for the preceding year. Corporate income tax is paid in monthly advance installments, by the 15th of the current month for the previous month. The amount of monthly installments is determined by the Tax Authority on the basis of the taxable income in the previous year and adjusted at the end of the year.

Positive Developments

In October 2006, the Serbian Government adopted the Draft Law on Changes and Amendments to the CIT law which addresses most of the problems present in the current text of the CIT Law, At the time of this report, the Draft Proposal is still pending adoption by the Serbian Parliament.

Remaining Issues

- Provisions governing taxation of permanent establishments are scarce and vague and do not provide sufficient guidance as to what constitutes a permanent establishment and how the profit subject to taxation is determined;
- Provisions governing transfer-pricing are general and rarely implemented in the practice. The lack of legislative guidance and any reliable practice in this area has caused significant uncertainty over how taxpayers should handle their related-party transactions;
- Certain limitations on the deductibility of expenses are inconsistent and unjustified, in particular with respect to the deductibility of advertising expenses, long-term provisions and severance pay;
- The obligation of resident taxpayers to pay withholding tax on capital gains generated by non-resident entities has caused significant difficulties in practice, in particular with respect to determining the acquisition value of the assets;
- Neither the CIT Law nor other relevant legislation clearly defines what are the underdeveloped regions where investment tax incentives can be applied.

FIC Recommendations

- The draft amendments to the CIT Law should be further worked on to address all outstanding issues on the basis of input from the business community and its representative associations such as FIC and other similar organizations;
- For major issues, such as taxation of branches and other forms of permanent establishments, and transfer pricing, separate by-laws should be issued to provide comprehensive and consistent regulation of these areas of corporate taxation.

B. Taxation of Individuals

Current Situation

Taxation of individuals is governed by the Personal Income Tax Law (the "PIT Law") adopted in 2001 and last amended in 2006.

Taxable Persons

The scope of an individual's tax liability depends on whether he/she is a resident or a non-resident of Serbia: residents of Serbia pay tax on their world-wide income, while non-residents are liable to pay tax only on their Serbian-sourced income. For individual income tax purposes, a resident is a person who:

a) has spend more than 183 days on the territory of Serbia, over a period of 12 months commencing and ending in the given tax year, or
b) has the center of his/hers vital interests on the territory of Serbia.

Income Subject to Taxation

Serbia's personal income tax system belongs to the category of the so-called "mixed system" which combines elements of the cedullar and synthetic system of taxation of individuals: different types of income are first taxed separately at different tax rates depending on the type of income. At the end of the year, the amount of taxpayer's total income exceeding the thresholds prescribed by the PIT Law is taxed additionally under the progressive tax rate.

Income subject to taxation includes salaries, income from capital (20%), royalties (20%), income from real-estate (20%), income from agriculture (14%), and all other income generated by the taxpayer (20%). The tax base is the gross amount of income reduced by the amount of standard deduction, depending on the type of income, or by the amount of real expenses incurred in relation to income and documented by the taxpayer.

Salary Tax

Salaries are taxed at a 12% tax rate. For purposes of the salary tax, an employee's salary is the remuneration received from the employer as well as any other benefit received by the employee from the employer on the basis of employment. The tax base is the employee's gross salary reduced by the non-taxable amount of RSD 5,000.

The salary tax is payable on a withholding basis by the employer and the employer is responsible for the calculation and payment of the tax. Salaries received from foreign employers from abroad are also subject to salary tax, under the same general rules, with the person liable for paying the tax being the employee – the recipient of the salary that is responsible for the calculation and payment of the tax.

Annual Income Tax

Residents of Serbia whose total annual income exceeds three times the average annual salary in Serbia are required to pay annual income tax. For residents-foreign nationals the threshold is higher and amounts to five times the average annual salary.

The tax base is equal to the sum of all income made by the taxpayer during the tax year, excluding dividends and certain other types of income specified by the PIT Law, and reduced by the amount of tax and social security contributions paid by the taxpayer during the year, and the standard deduction of 40% of the average annual salary in Serbia. Taxable income may be additionally reduced by the standard deduction of 15% of the average salary per dependant member of the taxpayer's family. Taxpayers whose income was taxed in another country are allowed a tax credit in the amount of tax paid abroad, but not more than the amount of tax which would have been paid on the same income under Serbian law.

The tax rate is progressive, and depends on the amount of taxable income:

a) for income up to six times the average annual salary in Serbia: 10%,
b) for income exceeding the amount of six time the average annual salary: 15%.

For residents – foreign nationals, thresholds are higher, and are as follows:

a) for income up to eight times the average annual salary: 10%,
b) for income exceeding the amount of eight times the average annual salary: 15%.

Tax Incentives

Companies which hire persons under 30 years of age are exempt from the obligation to pay tax on their salaries for a period of three years for trainees and two years for employees hired into other positions. Companies which hire disabled persons are exempt from the obligation to pay tax on their salaries for a period of three years. Companies which hire persons older than 45 years of age are exempt from the obligation to pay tax on their salaries.

Positive Developments

- Introduction of the non-taxable amount of RSD 5,000 and the lowering of the tax rate from 14% to 12% will reduce the tax costs for Serbian employers and, together with incentives introduced for certain categories of employees, stimulate employment in Serbia;
- Introduction of progressive taxation of annual income introduces more fairness in the taxation of individuals.

Remaining Issues

- Progression introduced by the latest amendments to the CIT Law is global, i.e. the higher 15% tax rate applies to the taxpayer's entire income not only on the income exceeding the threshold for the application of the 15% tax rate;
- The RSD 5,000 non-taxable amount of salaries is not consistently applied as, even though excluded from the taxation of salaries, it is included in the tax base for annual income tax;
- Higher thresholds of annual income tax payments for foreign nationals lead to discrimination of Serbian taxpayers without any plausible justification;
- Due to some recent opinions issued by the Ministry of Finance, the tax liabilities of foreign nationals working in Serbia continues to be a matter of considerable controversy in the practice.

FIC Recommendations

- Provisions regulating progressive taxation of annual income should be re-drafted to eliminate global progression;

- Taxation of foreign individuals should be dealt with systematically so as to remove confusion generated by inconsistent practices of the Tax Authority and the Ministry of Finance.

II. INDIRECT TAXES

1. Value-Added Tax

Current Situation

The value-added tax (VAT) is governed by the Law on Value-Added Tax from 2004. Serbia's VAT Law is modeled largely after the 6th EU VAT Directive, and most of the general VAT principles applicable throughout EU also apply in Serbia.

Taxable Persons
A taxable person is any person who independently carries out a business activity. Taxable persons whose total turnover in any 12-month period exceeds RSD 2,000,000 are required to register for VAT. Entities with annual turnover lower than RSD 2,000,000 and higher than RSD 1,000,000 may register for VAT but are not required to do so.

Taxable Transactions
A taxable transaction is the supply of goods and services made in Serbia, for consideration, and the import of goods. The supply of goods is the transfer of the right to dispose of the tangible property as the owner while the supply of services is any transaction which does not constitute the supply of goods.

Taxable Amount
Taxable amount is everything which constitutes a consideration which has been or is to be obtained by the supplier from the purchaser, including customs duties, excise duties and other public charges, except VAT.

Tax Rate
The standard tax rate is 18%. The lower 8% tax rate applies to certain categories of food, beverages, medical equipment, pharmaceutical products, hotel accommodations, utilities, newspapers and periodicals, and other goods and services prescribed by the VAT Law.

Persons Liable for Payment of Tax
Persons liable to pay taxes are the suppliers of goods and services. In cases where the supplier is a foreign entity, the person liable to pay the tax is the tax representative of the foreign supplier or, in cases where a foreign supplier has not appointed his tax representative in Serbia, the recipient of the goods and services (the "*reverse charge*").

Chargeable Event
A chargeable event occurs and VAT becomes chargeable either when the goods are delivered (the service performed) or when the price is received, whichever occurs first.

Deductions
VAT-registered taxpayers are allowed to deduct input VAT subject to the following conditions:

a) input VAT was paid in relation to supply of goods and services which are, or will be used for purposes of taxpayer's taxable transactions; and
b) the taxpayer holds an invoice drawn up in accordance with the formal invoicing requirements prescribed by the VAT Law, or an import document specifying the amount of VAT due by the importer.

Tax Exemptions
The VAT Law prescribes two sets of VAT exemptions: exemptions with the right to deduct input VAT (the 0%-rated supplies), including, *inter alia*, export of goods, related transportation services, international transportation, services related to the operations of free trade zones, etc. The second group of exempt transactions is exemptions without the right to deduct input VAT, including financial and banking services, insurance, educational services, services related to health care, etc.

Besides the standard VAT exemptions, applicable throughout the EU, Serbia's VAT Law provides certain specific exemptions such as for projects financed from international loans, international donations, and humanitarian aid.

Filing Requirements and Payment of VAT

Taxpayers whose annual turnover exceeds RSD 20,000,000 should file their VAT return and pay VAT once a month by the 10th of the current month for the previous month. Other taxpayers file their VAT returns quarterly.

Refund of VAT

The excess of input VAT, remaining after deduction of the taxpayer's input VAT from his output VAT, may be used as a tax credit and offset against the taxpayer's tax liability in future tax periods. Alternatively, the taxpayer may request the VAT refund. The Tax Authority is required to make the refund within 45 days after the expiration of the deadline for filing the tax return (10th of the current month for the previous month).

Refund of VAT to Foreign Taxpayers

The VAT Law provides the possibility of refund of VAT paid in Serbia to foreign taxpayers. The refund may be granted under the following conditions:

a) foreign taxpayer had paid the VAT,
b) VAT is deductible under general rules,
c) foreign taxpayer was not involved in the supply of goods and/or services in Serbia in the period for which the refund is requested, and
d) reciprocity with the applicant's country of residence.

Positive Developments

In 2006, the Ministry of Finance issued a couple of by-laws which clarified the position of branch offices, and refined and extended the VAT exemption for internationally financed projects.

Remaining Issues

- Rules relevant for the application of VAT Law are scattered over numerous by-laws, instead of being summarized in one act;
- Due to lack of clear legislative guidance and inconsistent practices of the tax authorities, many of the provisions of the VAT Law remain subject to considerable controversy in practice;
- Taxation of transactions involving real-estate is quite complicated and causes significant problems in practice;
- Due to inconsistencies in the VAT Law, the position of foreign entities within Serbia's VAT system is still unclear. This includes issues of what constitutes a permanent establishment, a foreign entity's business unit for VAT purposes, the position and VAT liabilities of persons appointed by foreign companies to act as their tax representatives, and the VAT registration of foreign entities in Serbia;
- Terms and conditions for VAT refunds to foreign companies are not clear, primarily with respect to the definition of supply of goods and services which prevents the VAT refund. In addition, the Tax Authority has not yet published any official list of countries with which Serbia has reciprocity with respect to VAT refunds.

FIC Recommendations

- The Tax Authority should issue comprehensive guidelines for the application of the provisions of the VAT Law to address various issues which have repeatedly been a source of problems in practice;
- Provisions of the VAT Law dealing with the position of foreign entities within Serbia's VAT system should be revisited and amended so as to create a coherent system of taxation for transactions involving foreign suppliers;
- Terms and conditions for VAT refunds to foreign entities should be regulated in detail and the list of countries with which Serbia has reciprocity should be published as soon as possible.

2. Customs Duties

Current Situation

Customs duties are regulated by the Customs Act from 2003 (the "CA"), that was most recently amended in July 2006.

Customs Duties
Customs duties are prescribed by the Customs Tariff and vary depending on the type of good. The classification of goods in the Customs Tariff is based on the Brussels Harmonized System. Rates prescribed by the Customs Tariff apply to goods which originate from countries that are designated with the status Most Preferred Nation (MFN). For other goods, rates prescribed by the Customs Tariff should be increased by 70%. For goods receiving preferential treatment, *i.e.* for goods originating from the countries with which Serbia has a free trade agreement, customs duties are lower than those prescribed by the Customs Tariff, depending on the terms of the treaty.

In general, for purposes of determining the customs value of the goods, the Customs Authority uses the transactional value of the good - the price paid for the goods increased by the amount of certain expenses payable by the buyer, as specified by the CA.

In addition to customs duties, imported goods are also subject to other charges, such as VAT, excise duties and fees for customs clearance.

Customs Exemptions
The CA provides three groups of customs exemptions:

a) exemption for specific categories of goods, including goods imported as a contribution in-kind, import of advertising material, import of exhibit items for international fares, import of goods for purpose of protection and registration of intellectual property rights, and goods sold in free trade shops at international airports;
b) exemptions for certain categories of importers such as humanitarian, educational, scientific organizations, etc;
c) diplomatic exemptions for foreign embassies, international organizations and members of their staff,
d) exemptions for good imported by natural persons, including personal items, pharmaceuticals, personal belongings, goods inherited abroad, etc.

Special Customs Regimes
The CA provides the following special customs regimes:
- inward processing,
- outward processing,
- bonded warehouse,
- temporary import,
- processing of goods under the customs supervision,
- transit of goods,

Goods are placed under a special customs regime on the basis of the decision of the Customs Authority, and are exempt from the obligation to pay customs duties their final importation in Serbia.

Positive Developments

With the latest amendments to the CA and the proposed changes to the Foreign Trade Law, Serbia has continued to move forward towards liberalization of foreign trade and simplification/harmonization of its foreign trade system with the EU and the WTO.

Remaining Issues

- Foreign entities are still not allowed to import goods in Serbia and the position of foreign companies' branch offices, with respect to the possibility to act as importers of–record, is still somewhat unclear;
- Interpretation of customs exemptions for the import of equipment is still restrictive and limits this incentive only to in-kind contributions of foreign parent companies to their Serbian subsidiaries.

FIC Recommendations

- Customs exemptions for the import of new equipment should be widened so as to cover all cases in which Serbian companies invest in the acquisition of new equipment, including both contributions in-kind and the purchase of new equipment from funds received through monetary contributions;
- Position of foreign entities and their branch offices within the Serbian customs system should be clarified and liberalized.

3. Excise duties

Current Situation

Excise duty is a consumption tax payable on certain categories of goods produced on or imported into the territory of Serbia. The excise tax is payable when the excise goods are shipped by the producer to the recipient.
Excise duties are payable on oil derivatives, tobacco products, alcohol beverages, certain kinds of imported non-alcoholic beverages, and coffee. The amount of excise duties is determined as a fixed amount per unit of goods, except for coffee for which excise duty is prescribed as a percentage of the customs value. The excise duties for excise goods are presented in the table below:

PRODUCT	EXCISE DUTY
Oil derivatives	RSD 16.66 – 32 per liter, depending on the type of oil derivative
Tobacco	RSD 2 per pack for domestic and RSD 10 per pack, for imported cigarettes + 40% of the retail price of cigarettes
Alcoholic beverages	RSD 9.00 to 136.55 per liter
Imported non-alcoholic beverages	RSD 3.50 to 5.42 per liter
Coffee	40% of the customs value

Excise duties are payable bi-weekly, by the end of the month for the first two weeks and by the 15th of the following month for the last two weeks. Excise tax returns along with the reconciliation of excise liabilities is filed quarterly and annually.

Positive Developments

In 2006, the Serbian Government came out with the Draft Proposal for Amendments to the Excise Law. At the time of this report, the proposal was still pending before the Serbian Parliament. The main changes include the deletion of the provisions governing the treatment of goods imported from and exported to Montenegro, the abolishment of excise duties on certain categories of oil derivatives, the abolishment of excise duties for imported beverages, the reduction of excise duties for coffee, etc.

FIC Recommendations

Any future amendments to the Excise Law and accompanying by-laws should be prepared in close cooperation with industries which are subject to the obligation to pay this tax, both in terms of their substantive content and in terms of the mechanisms for their implementation, as these have often been sources of difficulties for the taxpayers.

III OTHER TAXES

Property Transfer Tax

The property transfer tax is payable on the transfer of assets with consideration. Assets subject to taxation are immoveable property, intellectual property rights, shares and other securities, used cars, boats and aircrafts, and the right to use city construction land. The tax base is the contract price or, where the Tax Authority determines that the contract price is lower than the market price, the market value of the asset which is being transferred. The tax rate varies depending on the type of asset: 0.3% for the transfer of shares and other securities, 2.5% for the transfer of used vehicles, and 5% for all other cases. The person liable to pay the tax is the seller of the assets.

Real Estate Tax

The property tax is payable on the ownership of immoveable property such as land, buildings, and flats. The tax base is the market value of the real estate as of 31 December of the year proceeding the year for which the tax is assessed. The market value is determined by the Tax Authority on the basis of criteria prescribed by the law. The tax rate is 0.40%.

Chapter 10

ACCOUNTING AND AUDIT

Current Situation

The general framework governing financial reporting of Serbian companies is set by the Law on Accounting passed in 2006 and the set of regulations deriving from the Accounting Law, including the Chart of Accounts for Companies, Entrepreneurs and Cooperatives.

For financial reporting purposes, companies are classified in the following categories:

1. small companies
2. medium-sized companies, and
3. large companies

Criteria on which the classification is based on are:

1. average number of employees: 50 to 250
2. annual income: €2,500,000 to €10,000,000
3. average value of business assets: €1,000,000 to €5,000,000.

Companies which fulfill at least two of the three criteria enumerated above are classified as medium-sized companies. Companies having lower values in at least two categories are classified as small companies, while companies whose values for at least two categories are higher then those listed above are classified as large companies.

Companies are required to keep the following business books:

1. Journal
2. General Ledger
3. Sub-ledgers

Large and medium-sized companies are required to maintain their business books in accordance with the International Accounting Standards (IAS). Small companies may also apply IAS, but are not required to.

As a general rule, the financial year is equal to the calendar year. As an exception, foreign-owned companies are allowed to have an accounting year different from the calendar year, if their foreign parent's accounting year is different from the calendar year. The use of a different accounting year must be approved by the Ministry of Finance.

Large and medium-sized companies are required to prepare the following financial reports:

1. balance sheet
2. income statement
3. cash-flow statement
4. report on the changes in company's capital
5. notes with financial statements
6. statistical annex

With the exception of small companies, all companies are required to apply International Financial Reporting Standards (IFRS) as the accounting framework in preparation of their financial statements. In addition, companies having control over one or more related companies are required to prepare consolidated financial reports for the whole group.

Financial reports have to be approved by the General Meeting, or other competent body, in accordance with company's founding acts. The managing organ of the company is responsible for the accuracy and completeness of company's financial reports.

Financial reports of large and medium-sized companies, companies-issuers of securities, and companies which are required to prepare consolidated financial reports have to be audited by a licensed auditor, in accordance with the International Audit Standards. Auditor's opinion can be positive, opinion with the reserve, or negative, or the auditor may refrain from giving an opinion.

The Law on Accounting introduced the Chamber of Auditors which is currently in the process of setting up its bodies and organizational structure. The main activities of the Chamber of Auditors are to monitor the application and harmonization of IFRS, ISA and related rules, professional training of its members, issuance of auditor's licenses, and communicating with the Government on current accounting developments in the profession.

Large and medium-sized companies are required to file their annual financial reports to the National Bank of Serbia within the following deadlines:

1. Annual financial reports: by February 28th of the current year for the previous year;
2. Opinion of the auditor: by September 30th of the current year for the previous year. In cases in which financial reports were corrected on the basis of the auditor's opinion, the corrected financial reports need to be filed within this deadline as well;
3. Consolidated financial reports: by April 30th of the current year for the previous year.

Financial reports are also filed with the Agency for Commercial Registers within the same deadlines. Companies' financial reports represent public information.

Positive Developments

- The new Law on Accounting had addressed many insufficiencies of the old law, including, among other, the clarification of the independence of auditors, and the introduction of the possibility to have an accounting year different from the calendar year;
- Establishment of the Chamber of Auditors is a crucial first step towards organization of the Serbia's audit profession, particularly with respect to qualification, education and application of accounting standards.

Remaining Issues

- IFRS have not yet been translated into Serbian;
- The level of knowledge and understanding of IAS/IFRS, even though somewhat improved from last year, is still insufficient. There are many problems in their practical implementation related to private entities as well as financial authorities;
- The format of financial statements and other regulations issued by the Ministry of Finance deviate from IFRS in practice. Resolutions of the National Bank of Serbia applicable to banks and insurance companies over-rule certain standards, as is the case with IAS 39 and IFRS 4;
- Rotation rules for companies and banks are not in line with international standards which lead to a decrease of quality of audits in practice;
- The Law on Accounting simply extends financial reporting requirements applicable to companies to branch offices, without addressing any of the specificities of branch offices. This is the source of many problems in practice, both with respect to the way branch offices maintain their business records and with respect to their tax liabilities.

FIC Recommendations

- Personnel in state institutions, primarily financial and tax authorities, require extensive training in IAS/IFRS;
- Rules governing the rotation of auditors should be changed and brought in line with international standards to increase the quality of audits;
- Better coordination is needed, especially between accounting and tax rules, in particular with respect to accounting and tax reporting in branch offices.

Chapter 11

MEDIA AND MARKETING

Current Situation

- The main topic in 2005 and the first half of 2006 was the adoption and implementation of the Advertising Law. This law still creates a few uncertainties in the marketing area but affects businesses far less than in the previous year;
- The media scene in Serbia, regulated on the national level, remains very dynamic. This is evident in the interest demonstrated by foreign companies and investment funds in the shares of a couple of media and the forthcoming privatizations of certain broadcasters.

Positive Developments

- Initiation of the transformation of the national public broadcaster that should be completed during this year;
- Increased competition among national and local broadcasters that should impose higher program and production quality standards;
- Introduction of a transparent circulation declaring system for print media;
- Regulation of broadband networks;
- Increased usage of internet media.

Remaining Issues

- Insufficient implementation of the Advertising Law and numerous breaches of the Law – especially by local TV and radio stations;
- Local frequencies dissemination still remains open;
- Considerable decrease in the scope of technical (signal) coverage imposed on large regional and Belgrade TV stations;
- Lack of efficiency by the Serbian judicial system to process criminal charges in cases of false or offensive information about companies or individuals;
- General lack of media outlets support for corporate investments in projects of national significance.

FIC Recommendations

- More precise interpretation of the Advertising Law to be given by the Ministry of Trade and the Republic Broadcasting Agency (RRA);
- Conduct regional frequencies tendering competition in an open and transparent manner, avoiding controversies similar to those during the 2006 national frequency tender;
- Support further privatization of the electronic media owned by local municipalities in order to decrease potential political pressure and interference within the media;
- Define and improve technical standards for cable operators;
- Promulgate regulatory standards addressing anti-monopoly behavior of the operators;
- Conduct further restructuring of the cable TV network (by acquisitions, mergers, etc);
- Involve National Consumer Protection Organization as a third-party control tool;

- Due to the blurring of the lines between the media and telecom sectors, especially in areas such as Internet providers and VOIP (voice over IP), these sectors require clear laws, by-laws and regulation. See Chapter on Telecommunications.

Chapter 12

HUMAN CAPITAL

Current Situation

Serbia's labor market and work force have been slow to adjust to the changing economic situation. Therefore, there is an issue regarding the supply of educated and skilled workers into the market place.

An important element determining work force capability is the educational system. The supply of bachelor and masters education in Serbia has been significantly improved, but the quality of individual graduates still hasn't been proven in practice. In spite of significant autonomy in their work, state-funded universities tend to be rigid in their teaching approach. Private colleges are more innovative and flexible, however, there is no objective assessment of the quality of graduates that are being supplied to the labor market.

HR and placement firms fill a gap in the market in terms of assisting in the recruitment of quality personnel and providing training/education to companies' employees. However, these firms cannot meet all the needs of their clients and are not a solution to real structural problems that exist in the labor market.

The demand for skilled employees is increasing faster than the supply. Competition is rising among companies in the recruitment of quality, experienced personnel that is in short supply such as portfolio managers, CFOs, financial analysts and controllers, internal auditors, various HR, IT and marketing specialists. Additionally, there is pressure on companies to retain quality personnel. Companies are responding by becoming more proactive in offering incentives – for example, developing compensation & benefits packages within companies instead of traditional rigid payroll schemes.

Both the education system and people's mind-set must change. Older workers were accustomed to having secure, life-time employment with the same company. In such circumstances, education and training was not a priority with either the employee or the employer. Additionally, Serbia's work force has never been very mobile. Younger, new entrants to the labor force today are more willing to move to different locations; this attitude improves their employment possibilities.

Positive Developments

Since 2000, the number of international companies in Serbia is constantly increasing that, in turn, are introducing new trends in the Serbian labor market. Most importantly, their entry is accompanied by new business values. Many workers have adapted to the new circumstances and met companies' requirements and performance standards. Moreover, Serbia's labor force is buoyed by returning diaspora who worked abroad and obtained key skills/understanding that are demanded by international companies. As a result, foreign companies are increasingly appointing local staff to top positions instead of bringing in expatriate managers.

Increasing demand for the universities to improve their performance and to change their curriculum has affected most of the faculties, although not all of them are able to fulfill market needs. Knowledge and know-how are currently the most-wanted asset in Serbia.

Remaining Issues

There needs to be more vigorous dialogue, cooperation and coordination between many different groups – universities, government, unions and employers – in order to examine educational programs and ensure that graduates are being properly equipped for the labor market. In this dialogue, international companies should be represented. Additionally, representatives of international employers should not be selected by the government but rather FIC should select its own representatives.

FIC Recommendations

- Establish a forum in which all interested stakeholders can address human resources issues. This forum should be founded by the Government (involved ministries) and the FIC, and should meet regularly;
- Interested parties in the social dialogue should be clearly defined and the selection criteria transparently articulated for choosing company representatives. All decisions regarding social and labor issues should be reached through consensus;
- Establish a licensing system for HR professionals. This system should be developed by independent expert organizations and supported by involved ministries;
- Universities and major companies should establish close mutual cooperation in order that university curriculums reflect the needs of the business community and companies.

Chapter 13

CORPORATE SOCIAL RESPONSIBILITY

Current Situation

In Serbia, corporate social responsibility (CSR) is slowly gaining public attention. There is still a need for stronger promotion of this concept by all sectors. More intensive development of CSR would, as a consequence, have multiple benefits for Serbia as it creates a positive climate for foreign investors.

Positive Developments

The concept of CSR was primarily introduced in Serbia by NGOs and large international companies operating in Serbia. Gradually, many local companies started to understand the importance of this concept which led to a rise in the numerous social responsibility projects aimed at society development.

In 2006, under the governance of the Institute for Standardization, the Serbian Working Group for creation of the standard ISO 26000 was formed; the group is part of the UN-led working group. Thus, Serbia entered one of the most important global CSR initiatives which aim to have a significant impact on local developments in this area.

FIC participated in the organization of the first conference on CSR in 2005 where Mr Boris Tadic, the President of Serbia, appeared as the key-note speaker. Two more conferences on CSR were organized up to now.

Remaining Issues

- The general public is still unable to comprehend the correlation between business and social development. Furthermore, many executives are still confused about their role in the well-being of the society.
- The term CSR is commonly misunderstood or misinterpreted. In the majority of cases, it is associated with sponsorship, donation or other philanthropic activities. In addition, the profit sector often sees responsible business practices on the level of community projects only, overlooking the fact that it should encompass all internal and external segments of business operations: employees, market environment and community.
- The fact is that the majority still fail to grasp issues such as democratization of the society, good governance practices, corruption, consumer's rights, HR development, energy-efficient technologies, etc., as elements of corporate responsibility. The public should be able to obtain more insight into this area through relevant education and local expertise but, at this point, Serbia lacks both. That is why there is a pressing need for CSR experts and university programs on the market.
- There is a lack of cross-sector cooperation and undefined roles of sectors involved. NGOs demonstrate the greatest initiative, knowledge and motivation in this field. The Government could take a more active role in CSR development. Also, the media needs to understand the importance of CSR and draw public attention to this issue.

FIC Recommendations

- CSR should be recognized as a national strategy for improving competitiveness of Serbia's economy, as well as an element of a better business environment that would attract foreign investors. The Government should support the development and implementation of CSR business practices among both local and foreign organizations operating in Serbia through concrete measures that would stimulate such kind of behavior;
- The Government needs to regulate better the functioning of pubic enterprises and state-owned companies, since they often present a paradigm of irresponsible, politically biased and corrupt practices. State-owned companies top the list of the greatest polluters;
- The Government needs to be more active in ratifying and adopting a legal framework that addresses sustainable development;
- Development of CSR can best be achieved through joint action, where the Government should take a leading position by supporting the creation and implementation of the National CSR Platform. At the same time, a public awareness campaign should be created on a national level that raises general awareness of CSR and sustainable development principles among all stakeholders;
- Educational programs in CSR, sustainable development and related issues should be supported and introduced by the Government at universities.

SPECIFIC

Chapter 14

BANKING AND FINANCE

MANDATORY RESERVE REQUIREMENT

Current Situation

The current monetary policy, which aims to reduce inflation and deal effectively with the inflow of Euros into the country (a result of the privatization process and expansion of retail portfolios of Bank loans), has necessitated a tightening of the mandatory reserve requirements on deposits and loans received by banks during 2006. Mandatory re-deposits reached the level of 60% on short-term (under 2 years) and 40% on long-term (over 2 years) cross border funds of Banks. As a result, funding costs of banks increased substantially in 2006 but, due to increasing competition, such increases were to a large extent absorbed by the bank themselves.

Consistent with the marked reduction of inflation towards the end of the year, the NBS reduced mandatory reserve requirements in January 2007 to 45% for currency deposits and loans irrespective of term and to 10% for RSD deposits.
Concurrently the reference rate (RSD 15 day repo rate) was reduced from 18.5% in November 2006 to 13.5% at year-end and currently stands at 10%. The domestic interest rate environment is expected to be much more benign in 2007 with a shift of FX borrowings to RSD funds.

Nevertheless, costs of funds remains an important issue for Serbia, especially for exporting companies as well as for producers for the domestic market since external competitors operate under more favourable funding cost regimes.

Positive Developments

There is clearly an alignment of monetary policy with inflation targets and achievements, which may lead to further relaxation of the mandatory re-deposits regime on currency funds.

Remaining Issues

The steep reduction of RSD rates (in tandem with the reduction of inflation) may add complexities to the effort of the NBS to induce RSD deposits and loans, thereby reducing the "Eurozation" of the economy.

FIC Recommendations

- Active measures to substantiate the strength of the RSD on productivity gains and efficiencies rather than pure supply and demand;
- The strong RSD should continue to be supported by relatively high real interest rates for the RSD;
- Relaxation of the mandatory re-deposits regime in line with inflationary expectations.

LAW ON THE PREVENTION OF MONEY LAUNDERING

Current Situation

The Law on the Prevention of Money Laundering was implemented on 10 December 2005. The text of the Law was subsequently amended twice during 2005 and 2006. The Law has been fully harmonized with the EU Third Directive which will take effect as of November 2007.

Positive Developments

Efforts of the Administration for the Prevention of Money Laundering, Business Registers Agency and banks are finding efficient ways of mutual cooperation.

Remaining Issues

In accordance with this law, money laundering shall be understood to mean conversion or transfer of assets; concealment or disguise of facts about assets; acquisition, possession or use of assets and concealment of assets in the process of ownership transformation, with the intention to conceal or disguise that the assets originate from a criminal offence or from other illegal activity. In the context of this law, assets shall be understood to mean: things (movable and immovable); money (cash, effective foreign currency, Dinar and foreign currency deposits on accounts, as well as other means of payment); rights, securities and other title deeds evidencing the right of ownership or other rights.

Actions and measures for the detection and prevention of money laundering shall be undertaken before, during and after receiving, converting, keeping and using of the assets, depositing and withdrawing cash and effective foreign currency from an account, business operations which result in acquisition of assets or any treatment of such assets (*transaction*). Actions and measures for the detection and prevention of money laundering shall be undertaken by the banks, exchange offices, custody banks, banks authorized to trade in securities, leasing companies, etc (*obligors*). Obligors under this law are also lawyers, audit companies, legal and natural persons engaged in bookkeeping operations and tax advisory services.

Banks and other obligors are bound to establish the identity of the customers (private individuals, entrepreneurs, legal entities): when opening an account or establishing other forms of business cooperation; in case of any cash or non-cash transaction or multiple inter-related transactions with the total sum amounting to or exceeding €15,000 equivalent to the dinar amount; in the case of life insurance business; in case of any cash or non-cash transaction regardless of the value of the transaction, if there are reasons to suspect money laundering. Identification of offshore customers requires a special procedure. The obligor shall not be bound to perform identification in case of inter-bank transactions. Banks are obliged to establish the ownership structure of its customers, including private individuals holding over 10% of business share or stocks.

Supervision of the implementation of the Law on the Prevention of Money Laundering shall be conducted by the National Bank of Serbia, the Securities Commission, the Ministry of Interior, the Ministry of Finance and the inspection bodies.

FIC Recommendations

- Simplification of requirements for customer identification regarding ownership structure and other relevant information about large, globally-recognized companies, as well as banks and other financial organizations under the supervision of the competent regulatory body of its country; acceptance of the data from the web site of the Business Registers Agency and Central Securities Depositary as original documents, as well as from the known and accepted services (Reuters, Bloomberg, etc);
- Direct sending of data from the bank branches to the Administration for the Prevention of Money Laundering.

Chapter 15

LEASING

Current Situation

The law and accompanying regulations for financial leasing were adopted by the National Parliament in 2003 and later amended in 2005. With these changes, leasing companies became subject to supervision by the National Bank of Serbia (NBS). The NBS also was provided with significant authority to adopt the sub-legal decisions for implementing the Law on Financial Leasing.

Positive Developments

Development of new financing products in Serbia that allow companies and entrepreneurs to acquire needed assets.

Remaining Issues

- According to corporate tax regulations, legal entities and private entrepreneurs cannot obtain a tax credit (tax relief) for fixed asset investments financed by leasing. The problem is that ownership of property financed by the leasing does not receive equal treatment as property financed by own sources or bank loans. This regulation effectively prevents leasing from becoming a model for financing investment that in turn leads to growth in employment and production – as has been the case in other countries;
- The NBS has decided upon an ELIN formula for the leasing sector as well as an EKS formula for the banking sector. Both models represent effective costs (i.e. effective interest rate for potential borrowers but with a different calculation);
- If financial offers are requested from a leasing company and from a bank under the same conditions (including financed amount, period, interest rate, flat fee, etc.), the client will have higher effective leasing costs (i.e. ELIN) than effective banks costs (i.e. EKS). The reason that leasing is uncompetitive and more expensive is because the ELIN leasing formula includes VAT as a cost;
- For legal entities and private entrepreneurs who belong to the VAT system, this tax is a neutral category (no cost) since the VAT is refunded after a certain period. Not all legal entities and private entrepreneurs can refund VAT - only for equipment and vehicles which are used for registered business. In this situation, the leasing price does not have an equal position regarding the banks effective interest rate (i.e. price);
- Current regulations of the Ministry of Capital Investments address only ownership of property and short-term rent from 6 to 12 months for legal entities operating in international road transport. The problem is that regulations and conditions for obtaining the license ("Cempt") do not recognize financial leasing. For example, if an international transport company leases a truck, the company cannot obtain a license for the truck given that current traffic regulations do not calculate the rent or financial leasing on a period longer then 12 months. Due to this situation, the growth of transport companies as well as leasing as a promoter for economic growth is hindered;
- The Ministry of Finance has determined that invoices issued by leasing companies must include VAT on the purchase price plus VAT on the interest amount. In the case of variable interest rates in leasing contracts and a further increase or decrease of the contract administration, reconciliation for the tax basis with a variable interest rate has to be performed;

- New changes to the Traffic Law authorize government inspectors, when checking public transport carriers' compliance with legal requirements, to confiscate trucks, busses or other vehicles that the carrier used in committing a specified offence. This could be a problem in situations where the vehicle in question is leased and the vehicle, technically speaking, is owned by the leasing company. The Leasing Association has already submitted comments to the Ministry of Capital Investments regarding this issue. The Ministry has not responded to this issue;
- Also problematical are annual taxes with respect to leased vehicles. Because the owner of the leased assets is a legal entity (lessor), natural persons (lessees) are required to make payments in a higher tax bracket for legal entities - up to 4 times higher than taxes for natural persons. The Serbian Chamber of Commerce and leasing companies have jointly submitted a proposal for amending the relevant law so that taxes should be paid considering the status of the lessee and not the lessor. The government has not responded to this proposal;
- Pursuant to the Law on Financial Leasing, financed objects can only be movable assets (cars, trucks, equipment) and not real estate;
- According to the Law on Financial Leasing, financial leasing contracts must be signed for at least 2 years during which it is not allowed to pre-pay the financed object.

FIC Recommendations

- Corporate tax for legal entities and private entrepreneurs, who are investing in fixed assets via leasing, should foresee a tax relief comparable to the situation of investment by bank credit or self-funding;
- The ELIN leasing formula should be equal to EKS formula calculation for legal entities and private entrepreneurs;
- Integration of financial leasing and extending of rent period in traffic licensing regulations ("Cempt") in cases where legal entities operate in international road transport.

Chapter 16

INSURANCE

Current Situation

Life and Non-Life Insurance

Insurance companies and their activities are governed and regulated by the Insurance Law, adopted in 2004 and later amended, as well as related by-laws issued by the National Bank of Serbia (NBS). The NBS is the competent authority for granting and revoking licenses of insurance companies and performing the supervisory oversight of the insurance sector.

The Insurance Law regulates:

- Licensing of insurance companies – mandatory requirements concerning capital, organization, internal acts, policies and business plan;
- General terms of organization of an insurance company – requirements concerning act on foundation and articles of association, mandatory bodies (general meeting of shareholders, management and supervisory board and general manager), "fit and proper" requirements for their nomination;
- Actuary and internal audit issues;
- Reinsurance;
- Insurance agent and insurance broker activities and related licenses;
- Supervision of insurance activities by the NBS.

According to the new amendments to the Insurance Law, an insurance company are not permitted to engage in life and non-life insurance simultaneously. Also, insurance companies may engage in insurance or reinsurance activities only. An adjustment period for separation of activities - until 31 December 2007 – is envisaged for existing insurance companies. New companies must declare their field of activity at the time of incorporation.

Insurance Market Overview

As of the third quarter 2006, there were 17 insurance companies operating in Serbia: 14 of them performing only insurance, 2 of them performing only reinsurance and one performing both activities. This number will change in the near future, due to the legal obligation to separate insurance and reinsurance activities as well as to separate life and non-life activities. Furthermore, new foreign insurers are entering the market both through acquisitions and as greenfield operations.

There are 44 companies dealing with brokerage, agent and other activities related to insurance present on the local insurance market.

In 2006, based on third quarter data compared to the same period in 2005, the insurance market showed total growth of 12% equivalent to RSD 29.8 billion or €363 million. Expected total premiums written in 2006 is over RSD 40 billion, which is almost double compared to 2004.
Structure of the market is also showing signs of changes. The contribution to total written premiums of life insurance is 10.7%; this figure is encouraging but still low compared to most European countries.

Regarding non-life lines of insurance, property insurance was still the leading insurance product in 2006, although accounting for 1% lower than in 2005. Automobile insurance is a growing market segment, both in terms of own damage (casco) and third-party liability (mandatory) insurance. The new

Law on Mandatory Insurances is expected to be adopted soon, so more positive changes in this sector are anticipated.

Concentration of the market is still present as the three largest insurers in Serbia still account for a combined market share of more than 75%.

Although not significantly contributing in total premiums written in Serbia (26.4%), insurance companies with majority foreign ownership account for 83.5% of the life insurance market in terms of written premium. This structure will change in the near future, both due to the privatization processes and new investment in the insurance sector.

On the regulatory side, 2006 was the year which brought more precision in the insurance sector. Some positive results are: improved efficiency in claims payment, solvency became a more important issue and a new NBS integrated system for protection of consumer (insureds') rights is introduced at the end of 2006.

The Switch and/or Inclusion of Voluntary Pension Funds and Pension Schemes

The Law on Voluntary Pension Funds and Pension Schemes came into effect in April 2006. The Law stipulated that existing insurance companies, which performed voluntary pension insurance activities in accordance with previously applicable legislation, had until 31 December 2006 to adjust their operations. The following options were available:

- To register as a voluntary pension fund management company, organize a voluntary pension fund, and cease to exist as an insurance company;
- To continue operating as an insurance company while simultaneously incorporating a pension fund;
- To cease to perform voluntary pension insurance and transfer the entire portfolio to another pension fund.

Adjustment of activities and licensing by the NBS is still in progress.

Positive Developments

- The privatization of socially-owned insurance companies was initiated;
- First greenfield investments were made in the sector.

Remaining Issues

- Some Laws state that certain insurance lines are mandatory. Many laws do not prescribe minimum limits for such types of insurance and/or penalties for non-compliance. This produces an unclear situation with implementation;
- Two-step reinsurance is still present in the insurance market. Although intended as a positive measure to the local insurance market, in practice it often leads to "bottleneck" for placements of some insurance and creates possibilities for unfair competition. This situation is becoming more present and obvious with the entry of more international insurance companies. Furthermore, contrary to the previous Insurance Act, brokers are not allowed to deal with re-insurance which presents deficiencies in servicing and protecting interests of the insured;
- Separation of life and non-life has been postponed for 2007. In the process of registration/separation, clear transition procedures should be adopted. However, the real effect of separation and growth of the life insurance market would be more difficult without certain benefits for potential life-insurance buyers (companies and individuals) that could be provided by positive legal solutions, as is the case in many EU countries;
- Present legal solutions regarding health insurance still do not fully enable commercial insurers to develop and place their own insurance products;
- Existing insurance models present on the local market are mostly based on named perils insurances and tariffs, unlike in most EU countries. Increased demand for tailor-made and new insurance products (often initiated by foreign investors) is forcing Serbian insurers to broaden their offer; this will lead to a so- called underwriting model and ultimately to development of the insurance market.

FIC Recommendations

- The forming of a Central Register of Mandatory Insurance in Serbia;
- The abandoning of the two-step reinsurance principle by creating a more competitive environment and stimulating co-insurance procedures for insurers;
- Efficient, clear and flexible separation of life and non-life insurance companies by separation of funds, not shared services, branches and sales network;
- Consider possibilities for legally provided benefits which would stimulate potential buyers of life and health insurance, thus creating an environment for significant growth in terms of total premiums written as well as for transfer of liabilities from state institutions to commercial insurers;
- Transition from tariff to underwriting models to stimulate new processes and practices both within insurance companies and the regulator.

Chapter 17

VOLUNTARY PENSION FUNDS

Current Situation

The Law on Voluntary Pension Funds and Pension Schemes was adopted in October 2005, and the by-laws for its implementation, within the competence of the National Bank of Serbia, were passed in March 2006. Pursuant to the Law, the National Bank of Serbia will have the role of both the regulator and the supervisor in this field.

Positive Developments

- In mid-July 2006, the National Bank of Serbia adopted a professional testing program for persons who will be engaged in providing information on voluntary pension funds. The exam was organized in October 2006;
- In June 2006, the Security Exchange Commission (SEC) adopted rules on acquiring titles and licenses for brokers, investment advisors and portfolio managers. Pursuant to the Rules, four cycles of training courses and exams were organized for portfolio managers. To date, 11 participants in the training courses acquired diplomas in portfolio management;
- In early 2007, the SEC passed a decision on compulsory exams in the field legal framework regulating the functioning of the securities market, to be taken by all persons who applied for the recognition of diplomas acquired abroad. Thus, conditions for recognition of foreign diplomas were put in place.

Remaining Issues

- Public awareness on the value of such funds is still at very low levels in Serbia. Improved awareness will only be achieved through the combined effort of the funds and the Government;
- Insurance companies' harmonization with the Law on Pension Funds must continue at a vigorous pace, as such companies already offer voluntary insurance schemes that are based on investment management;
- A corporate bond market needs to be developed to broaden the horizon of investment alternatives for the funds, along with markets for equities and government paper.

FIC recommendations

- The privatization of large public enterprises should be conducted through the Belgrade Stock Exchange to establish a higher number of liquid shares and to expand the investment possibilities for the funds;
- The SEC should accelerate the process for recognizing the licenses of portfolio managers that were obtained abroad in order to enable the funds to hire appropriate people;
- Establishment of a corporate bond market dealing perhaps initially in bonds analyzed by banks (bankers' acceptances) to create investor confidence in this instrument;
- Due to the size of local companies and the small likelihood of international ratings being obtained by them, the funds should be permitted to invest a percentage of their resources in unrated paper;

- The National Bank of Serbia (as the supervisory body) - in cooperation with industry representatives - should evaluate the implementation of the Law in order to enable timely amendments of the regulations in accordance with the market needs (type of securities to be invested in, investments in foreign securities, quantitative limitations);
- Training and education in the field of voluntary pension insurance should be organized for employers and citizens. The Serbian Chamber of Commerce, with its regional network, could be the framework for the training and education of legal entities. Cooperation between all competent institutions is needed for the adoption and implementation of educational programs. Educational activities are of particular importance in the early stage of this sector's development.

Chapter 18

REAL ESTATE AND CONSTRUCTION

LAND OWNERSHIP

Current Situation

Private ownership of construction land is recognized through the 2003 Law on Urban Planning and Construction (LOUPC) and in the 2006 Constitution. Still, there are no general legal grounds for the privatization of these lands.

Several possibilities exist for land acquisition: leasing construction land (up to 99 years), acquisition of a transferable "Article 84 right of use" vested in the pre-nationalization owner, utilization (possible in practice) of the perpetual right of use (formerly the only way of holding a right to construction land until 2003) and freehold of agricultural land that can be converted into urban land (easy and less costly if not in the Master Urban Plan).

Positive Developments

The adoption of the new Constitution recognizes private ownership of construction land. In 2006, the LOUPC was amended, allowing multiple conveyances of the "Article 84 right of use" vested in the pre-nationalization owner. Prior to this amendment, such "right of use" was transferable in one instance only.

Remaining Issues

Key problems, identified as barriers to foreign capital inflow remain almost unchanged:
- Construction land remains almost exclusively the property of the State;
- There is a shortage of larger land lots in central urban areas;
- Lack of enforcement of Article 86 (LOUPC) in terminating right of use if buildings not constructed, on state-owned construction lands, in the prescribed period;
- Conflict between the Mortgage Law and LOUPC regarding construction permits on foreclosures of semi-completed structures (on state-owned construction land);
- Legal framework fails to address preferred land rights–leasing construction land;
- No Law on Property of Local Self-Governments to regulate responsibilities of local governments in disposing of construction land;
- Minimum prices for urban lands set by administrative acts instead of the market.

FIC Recommendations

- Restitution of construction land - develop process to ensure transparency;
- Privatization of construction land not subject to restitution;
- Creating industrial/technology parks (National Investment Plan);
- Increased application of Article 86 of LOUPC in terminating rights of use for state-owned construction lands;
- Adoption of the Law on Property of Local Self-Governments;
- Improve links between public offices, availability of data and training.

CONSTRUCTION

Current Situation

Although general urban plans are available, the completion of detailed plans and land records are still in progress. The Cadastre Project, funded by the World Bank, will be finished in 2010. Currently, 77% of immovable property is recorded in the central real estate cadastre.

Positive Developments

The new Mortgage Law became effective in February 2006, introducing some innovations for how/when mortgages can be established. Previously, a mortgage required the building's occupancy permit, making it difficult to finance projects in pre-construction/construction phases. Land previously could only be mortgaged if the mortgagor owned it. The new law allows registration of a mortgage for the following types of real property (where there is a building permit): (i) land on which a leasehold or right of use exists; and (ii) structures, including those still under construction, and parts thereof. In 2006, the Government funded 40 detailed plans throughout the country -- certainly a step in the right direction - but had little impact due to the limited scope of activity. Finally, SIEPA developed a database (internet accessible) listing over 400 investment locations, and several municipalities established "one-stop" information offices for foreign investors.

Remaining Issues

- Incomplete land and related records, contribute to irregularities/corruption in establishing ownership;
- Construction permit process remains corrupt, protracted and bureaucratic;
- Lack of clear regulations by local self-governments for leasing construction lands;
- The creation of the Central Registry of Mortgages, is still pending;
- The new Mortgage Law has not adequately strengthened creditors' ability to market pledged real estate and to decrease the time to collect receivables by permitting the mortgaging and foreclosure of properties under construction;
- Inaccessibility to needed data due to lack of information and/or unskilled staff;
- The construction sector remains predominantly state-owned.

FIC Recommendations

- Create complete, accurate land records, especially for lands for the construction of production/service facilities;
- Clear legal provisions to enable restitution, acquisition/leasing of construction land, regulating issuance of construction licenses and the criteria for determining fees for leasing, conversion, etc;
- Complete creation of Central Registry of Mortgages;
- Training of officials to ensure enforcement of the LOUPC;
- Develop a 'one-stop' office for development projects exceeding €5 million;
- Privatize the construction industry.

MUNICIPAL REAL ESTATE

Current Situation

Municipalities have failed to deprive holders of the perpetual right of use of state-owned construction land (Article 86, LOUPC) when buildings had not been constructed in a timely manner. A large number of retail and office properties in prime locations remain state-owned and managed by municipalities, often leased by municipalities at rental rates several times lower than actual market rates.

Positive Developments

There were no positive developments.The year was lost.

Remaining Issues

- Lack of clear leasing rules at municipal level results in unfair, non-transparent process;
- Lack of real property ownership by local bodies prevents them from raising funds through the pledging of property as security.

FIC Recommendations

- Introduce transparent procedures for municipally-managed properties;
- LOUPC should provide ownership/management rights to municipalities for real property that is not restituted or privatized.

RESTITUTION

Current Situation

No progress in promulgating a restitution law or policy.

Positive Developments

The Law on Restitution of Property to Churches and Religious Communities was adopted in May 2006. The Law prioritizes restitution in-kind. When not possible, beneficiaries are indemnified by the state or the present owner (if the latter cannot substantiate that the asset was acquired at a fair market price). The rights of bona fide individual acquirers of the assets are considered as vested. The process of documenting nationalized property was completed in 2006.

Remaining Issues

The absence of a restitution policy and law continues to hinder development and even some foreign direct investment.

FIC Recommendations

The law on restitution should be introduced without further delay.

Chapter 19

ENVIRONMENT AND CHEMICAL PRODUCTS (ADCPI)

ENVIRONMENT

Current Situation

- Serbia's Law on Environmental Protection came into effect in December 2004. The law empowers local authorities to independently apply and determine the amount of an environmental tax;
- In response to an initiative by foreign investors, the Serbian Government made significant efforts to regulate more precisely the calculation method and payment of the pollution and environmental protection tax. The proposed law was sent into Parliamentary procedure;
- Large industrial plants emitting harmful substances have been designated as taxpayers;
- Permitted limit values have been established for arsenic and nickel through amendments to the Rule Book on Emission Limits;
- Air protection hasn't been legally defined yet; decrees from 1991 and 1997 are still being applied.

Positive Developments

- Government's readiness to recognize and understand the issues encountered by foreign investors in their business activities;
- Actual activity with regard to changes of the existing or new legislation;
- A series of legal proposals (laws on waste and air) prepared for regulating this sector in accordance with European Union regulations.

Remaining Issues

- Tax levels for some companies still depend on negotiations with local communities, creating unequal positions for investors in Serbia;
- There is no uniform, functional follow-up supervisory system for the level of air pollution and there exists no updated database on air monitoring;
- The National Strategy for Waste Management has been adopted. However, additional time and financial resources are required to solve issues such as open/disorderly waste depots, irregular waste and dangerous substances handling.

FIC Recommendations

- Adopt legislation: Law on Changes and Amendments of the Law on Environmental Protection, Law on Air, Law on Waste Management, Law on Packaging and Packaging Waste and Law on Chemicals Management;
- Adopt promptly governmental decrees related to the above-mentioned laws that are to be applied;
- Implement the National Strategy for Waste Management and resolve the waste depot issue;
- Develop and implement economic mechanisms and other measures to that will stimulate the business sector's environmentally responsible behaviour;
- Sign and ratify the Kyoto Protocol;
- Accelerate concrete steps in making more operational the Environmental Fund.

ASSOCIATION OF DETERGENT AND COSMETIC PRODUCERS AND IMPORTERS (ADCPI)

Current Situation

The Association of Detergent and Cosmetic Producers and Importers (ADCPI) operates under the umbrella of the FIC because the current legal regulations do not provide an appropriate form of organization for an association of legal entities. ADCPI is a member of the International Association of Soap, Detergents and House Cleaners Producers (A.I.S.E). Initially, the idea behind the founding of ADCPI in Serbia was cooperation with A.I.S.E. on the Laundry Sustainability Project and to market the introduction of compact detergents to Serbia and Montenegro. The goal of the project is to affect positively the environment, reducing the use of chemicals and packaging, numerous advantages for the consumers and lowering logistic costs.

Positive Developments

Cooperation with the Serbian National Consumers Association and, depending upon the project, the Ministry for Science and Environmental Protection, the Ministry of Economy, and the Ministry of Health. For example, the Ministry of Health issued a certificate that ADCPI members hair colorants are not dangerous for the consumers.

Remaining Issues

- Further development of business activities in accordance with actual standards relevant for the production, labeling, advertising and distribution of detergents and cosmetics products;
- Protection of interests of ADCPI members regarding their rights and obligations according to current Serbian legislation.

FIC Recommendations

- Adoption of the Law on Chemicals, in line with EU legislation, and effective implementation;
- Closer cooperation between State authorities and institutions.

Chapter 20

TOBACCO INDUSTRY

Current Situation

The ratification of CEFTA, expected to occur in the course of 2007, will create a free trade area. This is a welcome development from the point of view of the Serbian economy. However, CEFTA will liberalize imports of cigarettes through the equalization of the excise tax on imported and domestic cigarettes. This situation changed the operating circumstances for the tobacco industry given that, at the time of investment, the international tobacco companies were promised a protective regime until the year 2009.

Realizing that it needs to honor commitments to companies that have invested close to a billion dollars in Serbia, the Government has adopted an Action Plan to compensate for the changed business circumstances created by CEFTA. The Action plan involves proposed changes to the Excise Law, the Law on Customs Tariffs, and the Tobacco Law.

Positive Developments

The Government has shown awareness of the fundamental change in circumstances under which the tobacco industry would have operated, had CEFTA been signed without provisions which will compensate for the changes caused by the Agreement. This awareness was followed by a concrete Action Plan which, to its credit, the Government created in close cooperation with the industry.

Remaining Issues

- The Action Plan has been adopted by the "caretaker" Government and, as such, will not take effect until the new Parliament converts the respective proposed bills into law. Until that time, the tobacco industry is exposed to financial threats which will inevitably occur with the implementation of CEFTA;
- Irrespective of the Action Plan, the industry points out the lack of institutional capacity to implement the existing Law on Advertising and, in particular, the lack of sufficient trained personnel (i.e., trade inspectors) as well as inconsistency in the interpretation of the Law.

FIC Recommendations

- That the new Parliament take into consideration the Action Plan package as soon as possible;
- Training of a larger number of trade inspectors and applying greater consistency in interpretation of the provisions of the Law.

Chapter 21

LAW ON MINING

Current Situation

The Law on Changes and Amendments of the Mining Act was passed by the Serbian parliament on 17 April 2006. The initiatives of the Foreign Investors Council were partly incorporated.

Positive Developments

- The Law implements reasonably satisfactory solutions to resolve the issue of legal security in the field of mineral deposits exploration and covers the transfer from geological research operations to the mining phase;
- Last year's establishment of the Geological Institute of Serbia, whose intended function is to operate as a national geological service, was surely a positive event.

Remaining Issues

Although it can be said that the passing of the Law established a more operational legal environment than the one previously in force, it however did not fully eliminate the unnecessary legal risks involved nor did it set up a clear legal framework ensuring effective and efficient state administration of mining operations. Clearly, the intention remains to regulate commercial geological exploration based on a separate Geological Exploration Act, resulting in unnecessary administration and overlapping jurisdictions between ministries and government agencies. Since the primary obstacles preventing the greater inflow of private capital into the mineral exploration sector and mining itself still stand, FIC is in the position to reiterate most of the initiatives that were proposed last year.

FIC Recommendations

- A license holder should be allowed to transfer freely all or a part of its rights to one or more other parties;
- Implement internationally recognized standards for regulatory and public reporting of exploration results, mineral resources and ore reserves, such as JORC Code (Joint Ore Reserve Committee Code);
- The explorer should be permitted to obtain rights to large areas of land but only for a limited period and subject to minimum annual expenditure requirements per unit area;
- Regulate geological exploration within the Law on Mining rather than within separate legislation;
- A mining license should be granted for at least 30 years, renewable for as many additional 10-year periods as needed until the resource has been economically exhausted;
- Royalties should not be based on a percentage of gross revenue or on a charge per unit of volume or weight;
- The Mining Law should include a provision against state expropriation or nationalization of any or all of an investor's assets. The Law should also include a provision for fair and reasonable compensation to the investor under those extreme and exceptional circumstances in which expropriation or nationalization might still occur.

Chapter 22

TELECOMMUNICATIONS

Current Situation

The lack of telecommunications infrastructure is still an essential obstacle for further development of the telecom sector and more efficient business operations. The poor quality of connections and underdeveloped internet access are the key elements for low utilization of broadband services.

Telekom Serbia, the state-owned fixed and mobile operator, still has a monopoly position in the field of landline network for telecom services.

There are currently three market players in the Serbian mobile marketplace: MTS, mobile arm of the incumbent Telekom Serbia, Telenor and Mobilkom Austria.

The main policy document of this sector is the Strategy for Telecommunications Development for the period of 2006-2010 that was formally adopted by the Serbian Government. The Strategy is based on the previously adopted telecommunications policy document, The Strategy for Development of the Information Society and the Frequency Allocation Plan.

Furthermore, the following laws regulate Serbia's telecom sector: Law on Telecommunications (2003), Law on Broadcasting (2002), Law on Planning and Construction (2003), Law on Life Environment (2004) and Law on Protection of Competition (2005).

The Republic Agency for Telecommunications (RATEL) and the Republic Broadcasting Agency (RBA) are established in accordance with these laws as independent, self-financing regulatory bodies. Both bodies undertake the role of regulating the telecom and the broadcast sectors, including issuance of individual licenses and general authorizations for different types of telecom operators and service providers (fixed and mobile operators or providers, CATV distributors, radio and TV emitters, Internet providers, etc.). Members of the respective managing boards are appointed by the Parliament. Conflicts of interest are forbidden by law.

By-laws still do not exist for many relevant areas of the telecom sector. There is a lack of relevant by-laws addressing competition and liberalization of various types of services (fixed telephony, data transmission, wirelesses broadband, digital TV, etc). Also, new technologies are still not regulated (WiMAX, VoIP).

Positive Developments

- Telenor invested €1.5 billion in Serbia with the acquisition of Mobi 63 (Mobtel) from the Government through a public auction in August 2006. This acquisition solved the problem of state cross-ownership in the field of mobile telecommunications – an issue that was hotly debated in recent years;
- The third mobile license was granted to Mobilkom Austria at a price of EUR 320 million + EUR 1 in December 2006. This was another positive sign of liberalization of the telecom market;
- The new Strategy for Telecommunications Development in Serbia for the period from 2006-2010 contains provisions related to further privatization and restructuring within the telecom sector, with the aim to improve the business operations in this sector.

Remaining Issues

- The Law on Telecommunications contains provisions regulating the full liberalization of telecom services except for open network provision (ONP) and local loop unbundling - meaning open for competition to give services to end-users in the fixed telephony network. However, the by-laws are still not in place;
- All existing alternative infrastructure (i.e. optical cable used for utilities purposes, broadcasting or other) should be opened for all kinds of telecom services;
- The New Strategy for Development of Telecommunications Sector for the period of 2006-2010 includes provisions on harmonization of the regulatory framework with appropriate EU legislation. However, the by-laws further interpret the Law on Telecommunications, especially those sections related to competition and further development of the telecom sector, have still not been drafted;
- The New Strategy foresees a plan for sector liberalization and defines the conditions and authority for issuance of new operators' licenses. The strategy also foresees: partial privatization of Telekom Serbia, building capacities and improving the level of competences in all state bodies engaged in telecom business, strengthening judicial bodies for resolving disputes in this matter;
- It remains to be seen how the telecom industry players will accept the proposal of gradual liberalization of fixed network. Also, lack of competition in fixed network will prevent development of the fixed telephony market;
- RATEL's competencies overlap with some of those of the government. For example, telecom operators are subject to double inspections from relevant government ministries and RATEL.

FIC Recommendations

In order to develop the telecom sector and achieve a competitive telecommunications market, one of the basic conditions required is predictable regulation. Therefore, we recommend the following:

- Continue development of the independent and competent regulatory bodies;
- Develop telecommunications by-laws in compliance with the EU regulatory standards, requirements and procedures;
- Develop interconnection regime in line with EU standards in the shortest possible time, given the presence of a number of operators and service providers in the Serbian market;
- Encourage the development of alternative infrastructure needs;
- Liberalize internal infrastructure and open up for use alternative infrastructure for all kinds of electronic services, with a focus on telecommunications and broadcasting;
- Introduce general provisions and guidelines for eliminating cross-subsidization in telecom sector;
- Continue efforts for restructuring or privatization of state owned telecom companies;
- Rebalance telecommunications tariffs on a cost-based price structure and using best practices from the EU regulatory bodies and the principles of the Telecommunications Law.