FOREIGN INVESTORS COUNCIL

Proposals for Improvement Of the Investment Climate in Serbia

March 2003

FIC is hereby emphasizing that, in the course of making this publication, FR Yugoslavia changed both its name to The Union of Serbia & Montenegro as well as its Constitution („Official Gazette of S&M“ No. 1 / 2003). Any reference in this publication to Yugoslavia should be, therefore, interpreted as reffering to The Union of Serbia & Montenegro i.e. to the Republic of Serbia.

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Foreword of the Secretary General

In July 2002 a group of major international investors in Serbia initiated, in partnership with the OECD Investment Compact for SEE, the foundation of the Foreign Investors Council (FIC) - befor representatives of the Serbian Government, Ambassadors, business leaders and multinational institutions.

The purpose of this organization is to share the experience and know how of international companies with the authorities in this country, in order to facilitate and to speed up the transformation of the economy. It is the conviction of FIC that Serbia has on oppertunity to compensate partly for its disadvantage of ten years of isolation by making use of the past learning experiences in CEE.

It is absolutely in the interest of FIC to create an investment climate, which would not just help to make daily business life easier, but also to attract more strategic investors that Serbia badly needs. In the background of an ongoing stagnation of the world markets, as well as the possible military intervention in Iraq, with all its political and economic impacts, the competition between countries in the region to attract foreign capital will only increase.

A clear and stable environment will ensure that foreign investors are entering the market with a full commitment in terms of invested capital, know how transfer and opening export markets. Serbia, because of its geographical location and relatively low production costs, combined with-skilled labor force, has, a big chance to benefit from the ongoing expansion strategy of investors in the region. Nevertheless, the success of the market reform and the further integration of Serbia into Europe will depend on the consequent implementation of reforms and a further stabilization of the country.

By publishing the "White Book", FIC aims to respond to the Serbian authorities on some chosen subjects, which are linked to several sectors of the economy. As a matter of course, it is understood, that, because of limited resources, this publication cannot cover all aspects of the Serbian economy and therefore to does not reflect the complete picture and status quo of the reform work of the government. It has rather to be seen as a process, which is repeated on a regular basis.

In addition, this book will also be a reference for the monitoring process of reforms set by the "OECD - Investment Compact", within the framework of the Stability Pact for South East Europe. This White Book is therefore a natural part of and complementary to the monitoring process of reforms set by the OECD - Investment Compact within the framework of the Stability Pact for South East Europe. The White Book is used by the OECD to feed into and amend the Monitoring Instruments of the "OECD - Investment Compact", where appropriate.

The book is a joint effort of a group of dedicated people, who would like to bring this country forward. I would like to thank in the name of FIC, all the members and contributors, who supported us in publishing our first "White Book". I do hope that this publication is not just a helpful tool for Serbian authorities, international institutions, embassies and existing investors, but also a good source of information for potential investors.

Belgrade, March 2003

Christoph Greussing
Secretary General of FIC

Chapter 1

The FIC - Introduction and Overview

Major foreign investors in Serbia established The Foreign Investors Council - FIC at the Official Foundation Meeting (Constituent Assembly) held in Belgrade on July 15th, 2002, with the clear mission:

"To contribute together with the authorities to a better investment environment for foreign and domestic companies on the market through open, informal dialogue between different willing stakeholders."

OECD - Investment Compact for South East Europe took an active part in this process which supports its objective of an improved investment climate in the region.

All 33 companies - current members of the Foreign Investors Council have a long lasting presence in CEE and would like to share their rich experience from the region with Serbian and Montenegrin authorities and to support the reform work of the Government. They also believe that they can draw substantial benefits from their various experience, common interests and economic strengths to build a better enabling framework for future business in Serbia, as well as in South East Europe.

The aims of the council are:

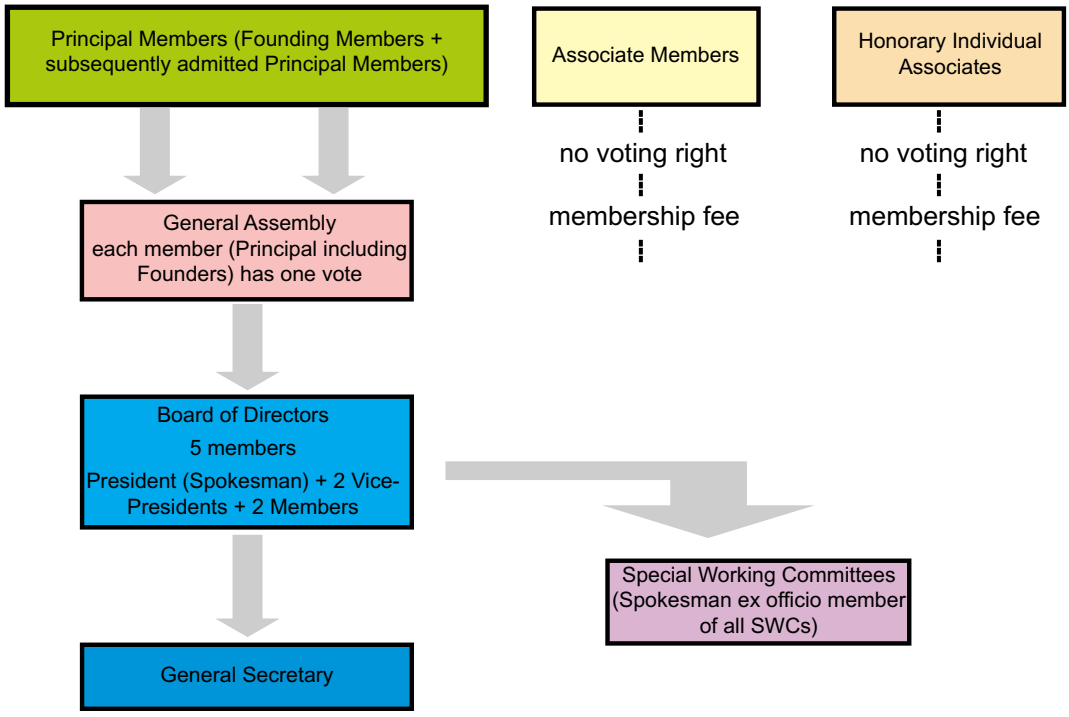
- Improvement of the investment and business development climate in Serbia by making concrete reform proposals;
- Stimulation of foreign direct investments;
- Promoting the communication between FIC and the Serbian authorities;
- Assise in overcoming difficulties which may exist in relations with foreign investors;
- Link with other foreign investor organizations across the CEE region to benefit from best practices sharing;
- Studying concrete means to facilitate regional operations;
- Facilitating the flow of information between FIC members and the Government

July 15, 2002 Foundation meeting of FIC together with IMF, OECD and the Government officials, Hyatt Regency Hotel, Belgrade

The FIC has been supported by the OECD and closely cooperates with major international organizations present in Belgrade, such as IMF, EBRD, IFC, The European Union, The Delegation of the European Commission, and the World Bank.

The Foreign Investors Council is established as a non-profit business association of foreign investors. The bodies of the Council are the General Assembly of the Council, the Board of Directors, the Spokesman, and the Secretary General.

FIC STRUCTURE OF GOVERNANCE



The White book, is a comprehensive set of proposals aimed at improving the investment climate in the country, was the next important milestone of the FIC business association.

The purpose of this White book is to present in a practical way, a constructive and positive view of what remains to be done in order to improve the investment climate in Serbia. It was written on the basis of the long-lasting experience of major foreign investors in the CEE region, and as a willingness to share their experiences with the Government and to exchange views on topics of mutual interest.

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Chapter 2

Country Overview

2.1. Key economic indicators

	1998	1999	2000	2001	2002e	2003f
GDP (real)	2.5	-17.7	6.4	6.2	4.0	4.0
Industrial output (real)	3.6	-23.1	11.2	-2.4	1.5	2.5
Consumer prices (annual average)	29.8	42.4	71.8	91.3	18.4	12.5
Unemployment (annual average)	25.4	25.5	26.8	28.0	30.0	30.0
Budget balance (% of GDP)	-7.4	-8.1	-3.1	-1.3	-5.7	-5.5
Current Account (% of GDP)	-4.8	-7.5	-7.6	-10.9	-12.8	-12.4
FDI (inflow net)	101	105	27	168	300	350
Gross foreign debt (% of GDP)	75.9	105.2	141.3	110.0	66.2	67.4
Import cover (months)	0.9	1.0	1.5	2.7	4.0	5.0
Average exchange rate (YUD/EUR)	10.5	11.7	34.9	59.4	60.0	66.0
Average exchange rate (YUD/USD)	9.3	11.1	37.5	66.7	63.8	64.7

Sources: National Bank of Serbia, Serbian Ministry of Finance and Economy, SIEPA, Serbian Statistical Office, IMF, CA IB estimates
e - estimate
f - forecast

2.2. Summary:

- Since coming to power in October 2000 the authorities in Belgrade have succeeded in stabilising the economy and establishing the foundations for further reforms. We are confident that the authorities will continue to implement the necessary reforms.
- Fiscal policy has been run prudently and tax reforms have been extensive. We expect continued prudent fiscal policy in Serbia and that the consolidated budget deficit will be 5.7% of GDP in 2002 and 5.5% in 2003, mainly as debt repayments have resumed.
- The National Bank of Serbia (NBS) has managed to reduce inflation and increase confidence in the Dinar. The inflation outlook is positive and we expect single figure inflation in 2004. The real appreciation of the Dinar is likely to present the NBS with a dilemma if exports do not grow adequately.
- The entry of foreign banks into the market and the closure of most insolvent banks augur well for banking sector development. Privatization initiatives are proceeding, aided by a transparent process, which the Serbian authorities have developed with international assistance drawing on the experiences of other transition economies.
- The resolution of the Paris Club debt issue is a major success for the authorities. However this has not yet been replicated in the London Club negotiations. The external debt position will remain partially defined until this issue is resolved.
- Legal sector reform, property rights definition and rebuilding of the industrial base represent the major tasks of reform initiatives in Serbia. International community support for dealing with the social costs of reforms will also be necessary over the first half of the decade in particular.
- Although we believe that the issue of Kosovo will be solved in a mutually satisfactory manner, the potential for intermittent political distractions remains.

2.3. Politics

The political situation in Serbia has become more complicated since the failed presidential elections. With the government's work being slowed down by ongoing tensions between the main political parties, the DSS and the DS, the elections had presented an opportunity to find a speedier solution to the impasse.

Both the election failure and the dispute over the outcome are disappointments for the West, which had urged voters to turn out and end political uncertainty.
The presidential election, two years after Milošević was ousted, was to pick a successor to Milan Milutinović, whose term ended in early January 2003 and was transferred to the Hague Tribunal shortly afterwards. He has been replaced temporarily by Serbian parliament speaker Nataša Mićić until a new president is chosen. The situation has been further complicated by the need for the Serbian and Montenegrin governments to agree on the details of an agreement for a looser confederation between the two states. After almost year-long negotiations both the Serbian and Montenegrin Parliaments approved the constitutional charter to form a looser union with Montenegro on January 27th and January 29th, 2003 respectively. The Yugoslav Parliament also approved the charter on February 4th, formally ending Yugoslavia's existence. The new constitution envisages Serbia and Montenegro as two nearly independent states, linked solely by a small joint administration running defense and foreign affairs.

The clear victory by Milo Djukanović's coalition in Montenegro's own early parliamentary elections in October 2002 has provided his party with a clear mandate to pursue its independence platform. The Montenegrin presidential elections failed on December 22nd because the turnout fell below the 50 % legal minimum.

We do not expect the resolution of political differences in Serbia in the next six months, which will have the potential to delay reforms. Meanwhile in Montenegro the parliamentary election results are likely to introduce a period of greater political stability, having provided the government with a clear mandate and parliamentary majority.

We believe that most major actors on the political stage in Serbia support closer ties with the EU and integration into Western organizations.

2.3.1. The Agreement on Principles of Relations between Serbia and Montenegro

On 14th March 2002 representatives from Serbia, Montenegro and Federal Yugoslav institutions signed an Agreement on the Principles of Relations between Serbia and Montenegro within the framework of a Union of States. The result of this agreement is to be a new Constitutional Charter of a Union of States called Serbia and Montenegro. With the charter adoption Yugoslavia is effectively consigned to history.
The Serbian Parliament approved the constitutional charter to form a looser union with Montenegro on January 27th. The Montenegrin Parliament approved the charter on January 29th, while the Yugoslav Parliament also approved the charter on 4th February.
The key elements of the Agreement are that Serbia and Montenegro will have separate economies, currencies and customs systems, but will have joint defense and foreign policy arrangements. Serbia and Montenegro will be represented at the United Nations and other multilateral institutions by one seat. Three years after the enactment of the Charter, Serbia and Montenegro will have the option of holding a referendum on whether to maintain the Union of States or seek independence.

2.4. Fiscal Policy

The Serbian government has taken significant steps towards putting fiscal policy on a sustainable path. Very good co-ordination with the National Bank of Serbia and guidance through the Extended Agreement with the IMF has helped reduce inflationary pressures despite significant administered price increases.

Until 2000 the Serbian government managed to keep the budget deficit low by compressing government expenditure, not servicing external debt obligations, accruing non-debt arrears and generating deficits in extra budgetary funds such as in pension and health funds.

In 2001 the adjustment in fiscal policy succeeded in reducing inflationary pressures, increasing revenue and improving the efficiency of state spending. Despite delays in the inflow of foreign financial assistance and lower than projected privatization revenues, the government was able to achieve a much lower deficit due to strong revenue performance and skilful expenditure execution.

Tax reforms and an anti-smuggling effort increased revenues. Sales taxes and various surtaxes were unified and a single consumption tax rate of 20% applied. Excise and surtaxes on excisable goods were also unified. The tax base for payroll tax contributions was widened; The contribution rate for both employers and employees is approximately 16%. At the same time a flat wage tax of 14% was introduced. The tax base for both of these taxes is now the gross wage. Corporate income tax was set at 20% with many Milošević-era incentives repealed or modified. This rate is to be reduced to 14%. Serbia intends to introduce a Value Added Tax at the end of 2003 or in early 2004.

Montenegro has also conducted extensive tax reforms introducing a personal income tax with three tax brackets ranging from 17-25%. As in Serbia, the tax base is the level of gross wages and includes most benefits. Corporate income tax is levied at two rates: 15% up to EUR 100,000 and 20% thereafter. Montenegro will also introduce a Value Added Tax of 17% with minimal exemptions and zero rates on 1st January 2003. In addition, excises have been streamlined and are levied only on alcohol, tobacco and oil products. These are not harmonized with Serbia.

The 2002 Serbian budget will see expenditure rise by 6% of GDP as international debt repayments resume and capital expenditures, severance payments and pension payments rise. In Montenegro expenditures will remain close to 2001 levels. Tax revenues in Serbia will also have risen in 2002 on the back of full-year effects of tax reform conducted in 2001. The consolidated general government budget deficit for 2002 is projected by the IMF to be 5.7% of GDP.

In mid-December 2002 the Serbian parliament approved the 2003 State Budget. The YUM 261.5bn (USD 4.3bn) budget envisages a a USD760mn deficit (3.8% of GDP). Public sector wages will rise 5% in 2003, which is consistent with IMF recommendations. The 2003 budget represents another milestone in the Extended Agreement with the IMF and should ensure the next tranche of money (USD 67mn) is transferred to Serbia in late January 2003.

Financing of the budget will be along similar lines to 2002. Projected privatization revenues represent the largest single source at USD 240mn (1.3% of GDP), International Finanacial Institutions will contribute another 0.8% of GDP in grants, while roughly domestic and foreign borrowing of USD 200mn each (1.0% of GDP) will finance the rest of the projected budget deficit. The Government plans to issue a mini-eurobond in the amount of EUR 40mn during 2003, however, further external borrowing plans have not been elaborated.

Serbia has also started pension reform. Reforms enacted in December 2001 increased the retirement age by three years for men and women to 63 and 58 years respectively. A new lower-cost pension indexation formula was adopted and the minimum pension was reduced to 20% of gross average wages, as opposed to 20-40% previously.
These reforms should generate savings of 1.1% of GDP in 2002 rising to 2.8% in 2005. Overall we view fiscal policy in Serbia as prudent, with the greatest risk still represented by external debt obligations, which are not yet fully defined. Reforms on the revenue side will improve the efficiency of the economy and boost revenues. At the same time, with little room for maneuver on the expenditure side and disciplined expenditure control in 2001 and 2002 we remain confident fiscal policy will continue to support economic development in Serbia.

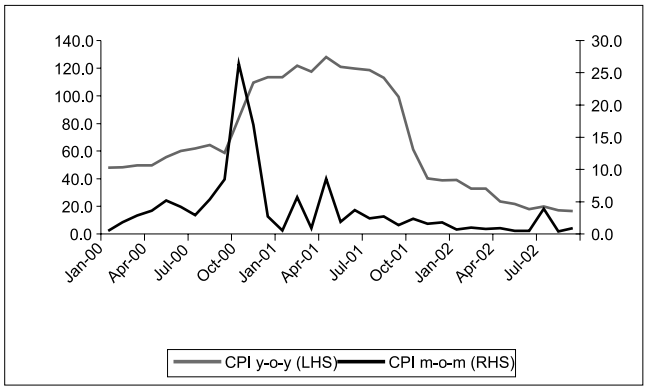
In Montenegro, following the 2002 election-driven rise in spending we expect the budget deficit to stabilize.

2.5. Monetary Policy

Since October 2000 the National Bank of Serbia (NBS) has managed to run a monetary policy which has succeeded in lowering inflation, building up foreign currency reserves and achieving a stable currency. Confidence in the currency is returning and interest rates have fallen. At the same time the real exchange rate has risen sharply, returning to historical levels.

The NBS set about lowering inflation and rebuilding confidence in the dinar by unifying the exchange rate and abandoning policy lending. Instead the NBS is sticking to a net domestic asset (NDA) ceiling determined together with the IMF and by ensuring that net foreign assets do not fall below a certain floor. The limited rise in NDA has allowed inflation to fall and rapid miniaturization of the economy to occur while the currency has remained stable. The inflation rate averaged 18.4% in 2002 and continued falling over the forecast period.

Graph 1 Inflation



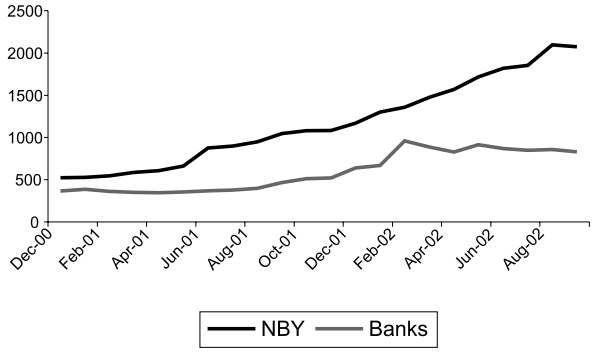
Source: Statistic Burreu Office

The rapid rise in net foreign assets (NFA) through purchases of foreign currency on the inter-bank exchange market has seen Dinars in circulation rise substantially as inflation and interest rates have fallen. Part of the rise in NFA has been sterilized through NBS bills.

The NBS does not have too many instruments at its disposal. It has so far focused on altering reserve requirements and selling NBS bills to manage liquidity. In April 2002 the NBS widened the deposit base for reserve requirements to include all broad money deposits (previously all foreign exchange reserves and selected Dinar deposits were exempted). The NBS also lowered the reserve requirement to 20% from the previous 24.5%. Four new lending facilities were also introduced and longer maturity NBS bills out

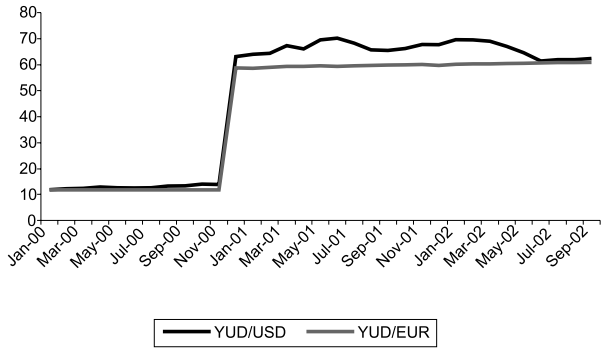
to 6 months were also introduced. Unusually the NBS sets the interest rate in advance for its auctions so NBS bills do not reflect true market demand for their instruments.

Graph 2 Foreign exchange reserves



Source: National Bank of Serbia

Graph 3 Exchange rate



Source: National Bank of Serbia

Monetary conditions are still characterized by excessive liquidity. This is mainly due to structural issues such as the 0.2-0.4% financial transactions tax, a dearth of lending opportunities, institutional impediments to liquidity management (since the Payment Institute carried out all payments), and, unattractively-priced deposit and lending facilities at the NBS.

The abolition of the Payments Institute (Zavod za obračun i plaćanje - ZOP) at the end of 2002 and the transfer of the payments system function to the banking sector has removed a key impediment to liquidity management and facitates the development of the banking sector.
The rapid growth rate of money supply indicates that confidence in the currency has increased. It is also a reflection of increased transaction demand for money as economic activity has picked up. The majority of EUR 760 mil. in foreign exchange deposits which have remained in the banking system were deposited by households. However, over EUR 3.2 bn in savings were withdrawn from the system following the conversion to the Euro.

Despite the rapid demonetarization, money supply as a percentage of GDP remains very low, at 11.5% of GDP in 2001 compared to 35% in Bosnia and Herzegovina and 53% in Croatia (based on M2). Little credit has been extended recently. Indeed credit growth has fallen over 60% in real terms in the year to August 2002 and, while interest rates have fallen, the spread between lending and deposit rates remains high.

2.6. External Sector

The current account deficit is high at an estimated 8.2% of GDP including grants in 2002. According to the IMF the deficit should fall to 7.0% of GDP by 2005 after rising to 9.5% in 2003. With the flow of aid projected to fall over the medium term the underlying current account deficit is improving.
In terms of financing the current account deficit, net FDI inflows should cover roughly 40% of the deficit.

Commercial lending and borrowing from international financial institutions will cover the rest of the deficit. Debt repayments will rise substantially from 2004 onwards.

Serbia's external debt position leaves it with little room to maneuver. At the end of 2000 external debt was USD 11.5 bn or 141.3% of GDP and 453% of exports of goods and services. By the end of 2001 Serbia had cleared arrears with the IMF, Eurofima, EIB and The World Bank.

Its greatest achievement to date regarding external debt restructuring has been to close negotiations with the Paris Club. The agreement envisages a phased 66% NPV reduction on debt. 51% of the debt was cancelled in 2002 while the remaining debt was rescheduled over 22 years with a six-year grace period. After the successful completion of the three-year IMF extended agreement a further 15% of the principal of the debt will be written off. However, there has been limited progress on negotiations with the London Club on the outstanding USD 2.3 bn debt. The price of the Paris Club debt has in the meantime risen considerably further weakening the Serbian negotiating position.

In 2003 debt service payments will be between USD 450 and 600 mil. rising to over USD 1.3 bn in 2010. This IMF projection is based on the assumption that Serbia manages to obtain comparable treatment for its London Club debt. In addition, this projection does not include defaulted loans and confessional borrowing.

The debt-to-GDP ratio should fall to 59% by the end of 2005. There are however, liquidity issues to consider in Serbia. According to the IMF the debt service-to-exports ratio should rise from 15% in 2002-2005 to 22% during 2006-2010. These calculations are based on assumptions of export growth of 12% over the remainder of the decade and rising FDI inflows. In addition, the IMF has assumed GDP growth of 5% per annum for the rest of the decade.

Given Serbia's high reliance on external borrowing to finance its current account deficit and its exposure to changes in investor sentiment, it will be crucial for the authorities to ensure access to capital markets and an investment environment supportive of foreign direct investment inflows. To these ends, successfully completing the IMF extended agreement and implementing coherent, market-oriented economic policies will be essential. A key first step remains concluding the London Club negotiations.

Inflation has fallen substantially since the current government came to power. The real exchange rate has appreciated sharply, lowering the price competitiveness of Serbian exports. The real exchange rate is near levels not seen since January 1998 and with export growth a key component of a sustainable external balance scenario, we believe another Dinar depreciation cannot be discounted in an effort to lower the current account deficit.

With economic factors exerting depreciation pressures on the Dinar in the short and medium terms, the NBS is likely to find it increasingly challenging to maintain its current policy of exchange rate stability. Should export growth or FDI inflows not meet expectations, external debt constraints will present the government with the difficult decision of possibly devaluing the Dinar. This may be necessary to rein in the current account deficit against the risk of increasing inflation, reducing trust in the Dinar and eroding purchasing power.

Chart 4 Euro based real exchange rate (January 1995=100)

Source: NBS, CA IB estimates

2.7. Banking Sector Reform in Serbia

In June 2001 a number of banks were put into liquidation or rehabilitation and the Bank Rehabilitation Agency was also reorganized. In Serbia 23 banks were closed including the four largest banks. The Serbian authorities had estimated the cost of rehabilitating the four large banks at USD 3.8 bn on top of London and Paris Club obligations and therefore decided to bankrupt them at a cost of just over USD 80 mil. Six new licenses have been issued to foreign banks since late 2000.

The Serbian authorities have also strengthened banking supervision by introducing new laws on banks, non-banks, and the central bank. They have also increased the number of employees in the banking supervision department of the NBS and the Bank Rehabilitation Agency. In addition, all banks which are still in government hands are drafting privatization plans. The government is hopeful of completing the privatization of all of these banks as soon as conditions allow.

In Montenegro bank reform commenced earlier with seven of an original 11 banks having being re-licensed. Since early 2001 the largest bank, Montenegro Bank, has been in administration. At the same time, a new law on banks and improved prudential supervision procedures consistent with international standards were introduced.

The entry of foreign banks into the market will increase confidence in the banking sector. Yet further efforts on behalf of the authorities will be paramount to building on a good start and increasing the efficiency of and confidence in the sector.

Privatization

In Serbia privatization is being carried out through public tenders and auctions. The largest 150 companies in Serbia will be privatized by tender, which is managed by the Privatization Agency (PA). The purpose of these tenders is to find strategic investors for these enterprises. The tender process envisages transferring part of the shares of these companies to employees and to the general public free of charge. Thus the tender process aims to sell 70% of the socially-owned capital of an enterprise to a strategic investor, the transfer of up to 15% of shares to employees and allocate the balance to the Share Fund.

Privatization kicked off with the sale of three cement companies to Lafarge, Holcim, and Titan for a total of about USD 150mil. in early 2002. Twelve tender sales were wrapped up in 2002, with another nine tender privatizations negotiated and to be closed in early 2003. Tender privatization receipts stand at around EUR 195.6 mil. Another EUR 82 mil. was committed to social welfare programs and EUR 282 mil. was committed for investments. A total of 44 of 83 minority stakes offered were sold, bringing in EUR 83.4 million.

Out of 210 companies up for sale in 2002, a total of 184 enterprises were sold (128 through public auctions, 12 through tenders, and 44 at the capital markets). The total privatization proceeds in 2002 are approximately EUR 300 mil. and almost as much were generated in investment commitments.

Most enterprises (over 7,000) will be privatized by auction. Most of these enterprises fall into the category of small- and medium-sized companies. The PA organizes the auction process in co-operation with the Belgrade Stock Exchange. The sale process is conducted by a commission which is appointed by the PA. There is a five-year time limit to complete the privatization process in Serbia. Thereafter, the intention is to distribute the remaining share capital in a mass voucher scheme.

In Montenegro the privatization process involved more methods but has advanced further with the completion the of Mass Voucher Privatization program in 2001, where an estimated EUR 1.25 bn of shares in government-owned enterprises were distributed among the population. The majority of citizens elected to transfer their shares to a Privatization Investment Fund to manage their portfolio.

With the MVP successfully completed, the Montenegrin authorities are mainly pursuing privatization through international tenders and to a lesser extent through batch sales (a combination of share sales and capital increases) and auctions.

2.8. Outlook

In the sphere of economic policy Serbia is faced with a number of challenges, which will see it dependent on international community support at least until 2005. Arguably the most pressing issue facing Serbia is the conclusion of external debt restructuring negotiations with the London Club. Apart from providing the Serbian government with a far more accurate indication of its external debt obligations for the remainder of the decade, the conclusion of this issue will clear a path toward achieving a credit rating and eventual access to international capital markets.

The other key issue in terms of general economic stability will be the ability of the NBS to maintain its current exchange rate policy. Up until now the NBS has managed to maintain a stable, slightly depreciating currency in nominal terms by reducing inflation, increasing confidence in the currency and purchasing foreign exchange in the local market, thus increasing reserves. At the same time, the real exchange rate has risen sharply, approaching historically high levels. With inflation projected to fall over the forecast period, maintaining the current exchange rate regime will reduce the price competitiveness of Serbian exports in the future.

As long as reserves are rising, the NBS should be in a position to maintain the Dinar's slight depreciation. The NBS will have to weigh up the benefits of exchange rate stability for the inflation outlook and social welfare against the need to attract foreign direct investment and boost exports. Overall we expect the NBS's exchange rate policy to come under increasing pressure, especially if the real exchange rate continues to appreciate. This is especially so since the many reforms at industry level which remain to be carried out in order to improve the efficiency of the Serbian economy will take time to devise and implement.

Export growth thus represents another key challenge in the next few years for Serbia. With Serbia's capital stock largely obsolete due to a decade of isolation and a lack of investment, the potential for sustained export growth is limited. Objectively, the main source of funding will be foreign direct investment, both in the form of privatization and "greenfield" investments as capital markets remain underdeveloped and the banking sector weak.

The key issues for the Serbian economy and challenges for government in the future will be the quality of the implementation of reform. In particular, these take the form of reforming Serbia's opaque legal system, clarifying the issue of land ownership and land registries, and enhancing the education system to produce individuals with the relevant skills for a market economy representing the major challenges.

These reforms will have to be carried out in an environment of extremely high social costs, as large numbers of jobs disappear with the restructuring of obsolete communist-era industries. Without continued international community support, through further debt relief, donor pledges and technical assistance the issue of managing the social costs of reform could slow progress on the implementation of reform.

Politically, the greatest risk is presented by the as yet undefined shape of Serbia. Namely the issues of Kosovo (and Montenegro) remain partially unresolved although independence movements in both places are strong. We are confident that a mutually-satisfactory solution will be found in both cases by the second half of the decade. It is now the interim period. We consider the key issues to be the effect of the political ramifications of finding a solution to these issues on public opinion, the pace of reforms in other areas and the perceptions of the risk of doing business in Serbia, which we consider to be the key issues. To that end the risk of intermittent political instability in Serbia cannot be ignored as various political parties attempt to capitalize in the short term on opportunities offered by negotiations over the status of Montenegro and Kosovo. In the longer term, as Serbia's relationship with the EU develops and candidacy for EU membership becomes relevant, the issue of minority rights in Vojvodina will also become more important.

2.9. Conclusion

The Serbian authorities have done an excellent job in starting the tasks of integrating Serbia into the international community and reconstructing the economy following the fall of the Milosevic regime. Intermittent political distractions cannot be discounted, particularly in connection with the status of Kosovo and Montenegro. However, provided international community support continues and the authorities focus on the reform agenda, we believe that Serbia will build on its good start and evolve into a modern economy.

Chapter 3

Legal and regulatory framework

3.1. Constitutional Framework

The fundamentals of the legal system of the Federal Republic of Yugoslavia (FRY) were laid down in the Constitution passed in April 1992. Under this act, FRY is a democracy with a parliamentary representative system. The legislative power is vested in a bicameral Federal Parliament that comprises the Chamber of Citizens and the Chamber of Republics. Each of the two federal units, Serbia and Montenegro, has its own constitution which must comply with the federal constitution of Yugoslavia.

Following the lengthy public debate, on February 4th, 2003, the FRY underwent a constitutional change to become a loose federation of Serbia and Montenegro. The Constitutional Charter and Implementation Law were enacted and are currently waiting for the official proclamation to enter into force.

The new state will hold a less extensive set of competencies, primarily in areas such as defense, international relations, human rights protection, common market and border control. The country will be governed by the President, a unicameral Assembly and a five-member Council of Ministers (foreign relations, defense, internal and external economic relations and human and minority rights). The country will have a joint army. The Court of Serbia and Montenegro that will have jurisdiction over the remaining narrow set of constitutional and administrative matters.

The Federal laws of the former FRY not pertaining to the areas within the jurisdiction of the new state will be transferred to the level of the federal units until new laws are enacted. The assemblies of the federal units may decide not to apply certain particular laws. The Constitutional Charter mandates the federal units to adopt new constitutions within six-months of adoption of the Charter.

To date, existing federal institutions will be transferred to the Serbian level, such as the NBS, the Federal Customs Authority, the Bank Rehabilitation Agency, the Federal Securities and the Exchange and Anti-Money-Laundering Commissions and Foreign Currency Inspectorate.

Following the expiry of the stipulated three-year transitional period each member unit may initiate the necessary procedure for dissolution of the joint state.

The legal system of FRY is based on the principles of Roman Law and Continental Civil Law, thus enabling private ownership rights. The main sources of law are the Laws enacted by the parliaments. The legislative powers are separated between the federal level and the republics. Due to the recent political conflict between Montenegro and the federal state, Montenegro produced its own legislation in matters that were within the jurisdiction of the federation. This has resulted in an anomaly whereby there was a conflict between federal and republic legislation in Montenegro. The Constitutional Charter seeks to clarify this situation.

The Union of Serbia and Montenegro Constitutional Court and Serbian and Montenegrin Constitutional Courts have the authority to rule on the constitutional validity of the laws enacted by the Parliaments and on Government or executive actions, and it can order their repeal. These Courts can be accessed directly by anyone.

3.1.1. Court System

Each republic has its own system of courts, public prosecutors and public attorneys. The Constitutional Charter provides for the creation of the Court of Serbia and Montenegro. Each of the two republics has civil courts of general jurisdiction and specialist commercial courts.

The court system of general jurisdiction within each republic consists of the Supreme Court, county/district courts and municipal courts. Most of the caseload in civil matters is dealt with before the municipal courts, while commercial courts adjudicate commercial matters. County/district courts and a Higher Commercial Court have appellate jurisdiction. The Supreme Court acts as the final court of appeal for all decisions that do not relate to constitutional issues.

The Serbian judiciary tends to be slow. Slack procedural laws enable defendants to delay the conduct of the proceedings. Furthermore, the large caseload for each judge also contributes to the inefficiency of the court system.

Judges must have a degree in Law and have passed the Bar exam as well as accumulating several years of experience. They are appointed for life by the Parliament.

Commercial contracts entered into in Serbia where at least one contracting party is a foreign legal or natural person, may incorporate arbitration clauses invoking the jurisdiction of the foreign or domestic institutional arbitration tribunals, including ad-hoc arbitration. Such commercial contracts with a foreign entity as a party may provide for the foreign substantive law to the prevailing law, so that Serbian law does not have to be the governing law of a contract entered into in FRY.

Guarantees of protection for foreign investors are stipulated in the Yugoslav Foreign Investors Law (FIL), which came into force on January 19th, 2002. This law provides that foreign investors have national treatment, i.e. gives foreign investors the same treatment in terms of rights and obligations, as domestic ones.

In addition to the listed protection provisions former, FR Yugoslavia has to date concluded bilateral Agreements on Foreign Investment protection and promotion with several countries including the Russian Federation; Romania; China; the Czech Republic; Slovakia; Poland; Bulgaria; Macedonia; Germany; Belarus; Greece and Croatia.

Positive Signs:

- The issue of the constitutional status of the country has been negotiated and progress has been made to define the status of the new Union. Further instability which has been inevitable throughout this transition process will hopefully be resolved soon.
- Within the court system, the process of training judges in new areas of law and international legal instruments has begun. A number of international organizations are advising on and funding a court system review to introduce a more efficient and transparent judiciary and administration.

FIC Recommends:

- Although the negotiations have concluded regarding the Constitutional Charter and Implementing Legislation, there remains a cloud of legal uncertainty regarding the entire process, international pressure and the three-year moratorium.
- The civil court procedure should be strengthened to facilitate the procedural discipline of the parties, as well as efficient and speedy conduct of the trials. A greater number of judges need to be trained and the current caseload per judge should be reduced. The necessary enlargement in the number of judges should enable courts to provide specialized judges for particular areas of Law.

3.2. Company Law

The Yugoslav Company Law is a Federal Law that regulates in detail all aspects of incorporation, corporate organization and management in all types of companies that may be established in Yugoslavia.

However, in specialized areas such as insurance, banking and stock exchange, particular laws are in effect and the general provisions of the Company Law are applied only supplementary.

Due to the political situation at the time, the Montenegrin Parliament adopted the Montenegrin Company Law on January 29th. 2002, which is only applicable in the territory of the Republic of Montenegro. Hence, although a federal law, the Company Law is in practice applicable only in the territory of the Republic of Serbia.

Since the latest amendments to the Law on Foreign Investments that took place early in 2002, foreign persons, both legal and natural, are generally given the same legal status with respect to establishing companies in Yugoslavia.

There are four types of companies that may be established under Yugoslav Company Law: partnership, limited partnership, Limited Liability Company and Joint Stock Company. All four types of companies have the status of a legal entity. The first two - the partnership and the limited partnership - are rarely seen in practice although the Law does not stipulate the requirements with respect to the minimal amount of their share capital. The founders of a partnership and limited partnership, usually natural persons, are liable with all their assets for the obligations of the company itself.

The most commonly used legal form in FRY is a limited liability company. It is a separate legal entity having a minimum of one and a maximum of 30 shareholders, who can be either legal or natural persons. The liability of the owners is limited to their share in the company, i.e. the liabilities of such company cannot pass to the shareholders except in very unusual circumstances. Shares of a limited liability company are expressed in percentage terms. In other words, a shareholder may have only one share expressed as a percentage. The share capital may consist of Yugoslav Dinars, hard currency, or any contributions "in kind" such as equipment, goods, know-how, etc. However, the minimum monetary share capital is USD 5,000 half of which (USD 2,500) is payable prior to registration of the company. The remaining half is payable within two years of registration.

A joint stock company has two forms pursuant to the Law, the closed joint stock company and the public joint stock company. As the minimum amounts of the initial monetary share capital are higher than those of the limited liability company (USD 10.000 for closed joint stock company and USD 20.000 for a public joint stock company), the registration procedure is more complicated. There are no developed stock exchanges, share markets or publicly listed companies. Therefore the companies established in the form of the joint stock company are predominantly in businesses such as banking, insurance, stock exchange, which, by virtue of special regulation must be established in the form of joint stock companies.

The latest amendments to the Company Law were enacted in July 2002. These amendments simplify the process for obtaining permits necessary for commencing operations of newly established companies; remove the company's liability for obligations of its subsidiaries; facilitate the privatization process by overriding management frustration of the privatization process.

The opening of a Representative Office in Yugoslavia is governed by the Ordinance on Detailed Conditions for Opening and Operation of Representative Offices of Foreign Persons in Yugoslavia. This provides for a registration procedure in the Register of Representative Offices of Foreign Persons at the Ministry of Foreign Economic Relations. The distinguishing feature of Representative Offices is that they are not legal persons and are to be used for the purposes of surveying the market and preparation of contracts to be concluded with the parent company.

Positive Signs:

- The aim to establish a one-stop shop to facilitate the establishment of a company or business presence is welcomed by foreign investors.
- The registration procedure appears to be taking up to four weeks at the moment. A year ago it could take up to six weeks. So the process appears to be more efficient. There is no longer a requirement to have the foreign investment registered with the Federal Ministry of Foreign Affairs.

FIC Recommends:

- Yugoslav laws and regulations appear to be inconsistent and insufficiently clear (e.g. whether the Company Law applies to banks with respect to the issues not regulated by the Banking Law). This should be clarified in further legal amendments to key sectors.

- There is a lack of the corporate experience (particularly in establishing joint stock companies) and a lack of relevant and consistent court practice in corporate issues. This results in substantial judicial discretion and legal uncertainty for commercial entities in Yugoslavia. We recommend that the Judiciary are properly trained and held responsible for following clearly defined judicial practice in company matters.

3.3. Privatization

The Law on Privatization (Zakon o privatizaciji) provides the legal framework for the process of privatization in Serbia. This law reflects the aspirations of the reform-minded government to have a quick privatization process and has the benefit of experience of other countries in transition. It provides for the privatization of up to 70 % of the state or socially owned capital within a period of four years. The Agency for Privatization was established as the legal entity that promotes initiates, carries out and controls the privatization process. In addition, this Law provides for three other legal entities established in order to enable the privatization process.

These are:

- The Share Fund which receives shares that are transferred to it for sale;
- The Central Registry for Securities which maintains a database of all issued shares;
- The Privatization Registry that records the part of capital of the entities to be privatized, expressed in shares, transferred to citizens free of charge.

There are two models of privatization of the socially owned and state owned capital which are (i) sale of capital; and (ii) transfer of capital free of charge.

The sale of capital and property of the entity to be privatized is undertaken by public tender or public auction. The tender process is used for larger companies and the auction process is used for smaller enterprises. The transfer of capital free of charge is implemented on completion of the sale of the capital by transfer of shares to employee and transfer of shares to citizens.

The legal entities with socially-owned capital could sell 70% of their socially-owned capital. The remaining socially owned capital is transferred to the employees free of charge or to the Privatization Registry, which should distribute the shares to the citizens two years after the completion of the privatization process (registered in the Privatization Registry). Companies which have been restructured prior to privatization can sell up to 100% of their capital or assets to the potential purchaser.

Positive Signs:

- In the first year of privatization great effort was made to establish the institutions involved in the privatization process and ensure they are functioning effectively.
- Thanks to a World Bank donation, a number of companies were placed in pools and advisors were appointed to carry out the tender privatization. A number of these companies have been successfully sold. The auction procedure commenced early 2002 and has been accelerated to 100 companies a month from December 2002.
- The Company Law was amended in August 2002 to negate the effect of obstructive management in the privatization process, thereby authorizing the Ministry for Privatization effectively to overrule obstructive management

FIC Recommends:

- Foreign Investors should be given sufficient time to properly conduct their due diligence on the company being privatized. Whilst the urgency felt by the Privatization Agency to privatize is appreciated, it is important that the foreign investors have enough time to gain the correct picture of the company they will to invest into.
- In the early privatizations great emphasis was put on the social program investment that investors made. This resulted greatly increasing the level of investment. FIC recommends that a more realistic attitude be taken by the Agency for Privatization in the negotiation of this point. In this way quality investors will not be lost because of the prohibitive social program costs.

3.4. Concession Law

Concessions represent an important form of foreign investment. They are governed by the Concession Law whereby a concession is defined as the right of use of a natural resource or use of property in general, granted by the competent government authority to a national or foreign subject, under certain conditions, for suitable consideration. There is a draft new Concessions Law which is expected to be before the Parliament before the end of 2003.

Both the current Law and the current Draft Law, provide for a special form of concession known as the Build-Operate-Transfer (BOT) system which is based on the building and financing of a complete facility, construction or department, use of it and delivery to the Republic of Serbia within the time period as agreed, but not longer than 30 years (according to the current Law) or 50 years (according to the Draft).

Other provisions relate to:

- extension of the subject of concession (e.g. building and use of the energy facilities or reconstruction of those facilities; distribution of thermal energy; postal services; building, reconstruction and use of state-owned facilities);
- extension of the time period for what the concession (as well as the BOT system) has been given (50 years);
- government authorities (the Government of the Republic of Serbia and the competent Ministry) competent for granting concessions ;
- public auction;
- registration of the Concession Agreement;
- company for undertaking of concession activities (either limited liability company or stock company);
- tax credits (may by approved by the decision of the Government of the Republic of Serbia); and
- Interruption (temporary) and termination of concession.

Positive Signs:

- The Draft Concession Law reflects the intention of the Government of the Republic of Serbia to improve and clarify the conditions for foreign investors.

FIC Recommends:

- The Draft law should be finalized and passed so that investors can be clear as to the environment they are investing into. The Draft Law should clearly address the inconsistencies between the Federal and Republican Laws relating to concessions. This is particularly the case in light of the constitutional changes with respect of the Union of Serbia and Montenegro.
- The Procedure whereby concessions are granted should be clearly prescribed and in line with public procurement legislation.

3.5. Labour Law

Following a lengthy public and parliamentary discussion, the new Labour Law came into force December 21st, 2001. The new law is very free-market oriented and comes as a response to the major economic and social changes that call for more flexibility in the labor market of Serbia. The most important feature is that in comparison with the previous labor regulation, the new law is more liberal regarding employment procedures and termination of employment giving more flexibility to employers.
Collective Agreements used to be an important instrument in the hands of the Unions and workers. Under the new Law conclusion of a collective agreement is not mandatory anymore. The parties are obliged to negotiate, but if the negotiation does not result in an agreement, rights and obligations can be regulated by the employer's Employment Rules and/or the employment contract. Furthermore, the new law provides that agreements create obligations only for those employers who are members or who become members of the association that took part in the bargaining. This represents a change from the

old regulation which provided that all employers from a certain field were directly obliged by the relevant agreement whether they took part, directly or indirectly, in the bargaining or not.

In response to the rapidly changing economic environment the new law makes it easier for employers to hire labour for a definite period (as in temporary employment). However the term of such relationship is still limited to a maximum of three years, an attribute of the old system, so as to eliminate the practice of repeatedly extending employment contracts for definite periods.

Criteria and elements of salaries were previously determined in great detail by the law and collective agreements. The new law just states that employees are entitled to equal pay for equal work, gives general elements of the salary and leaves it to employers to determine the specific criteria. In a similar spirit, employees are guaranteed at least 18 working days annual vacation and unlike the previous legislation, the new law does not provide for a maximum length, nor does it set criteria to determine the length of the vacation.

Termination of the employment by the employer is an area that has undergone major changes. The contract can be terminated only for a just cause concerning the employee's working capability, skills or conduct and the employer's needs, whereby just cause is broadly defined giving the employer lots of freedom and is deemed to exist in particular in the case of unsatisfactory working results, lack of the required knowledge and skills, misbehavior at work, criminal acts in connection with work, absence from work upon termination of the unpaid leave, misuse of the right for sick leave or layoffs due to the economical, technological or organization reasons. The termination procedure is simplified and the severance payment in case of the layoff is considerably reduced. (The old law provided for the amount from 24 up to 36 monthly salaries. Under the new law, employees are entitled to a severance payment starting at double the monthly salary up to five monthly salaries, depending on the duration of the employment).

Positive Signs:

- Representatives of the government of Germany, the World Bank and the International Labor Organization took part in the drafting of the Law, and the new Labour law included their recommendations in many areas. The new law eliminated those features of the old regulation that were viewed as overly protective for workers and highly restrictive for managerial functions. It now tries to achieve the balance between the necessity for greater flexibility of the labour market, which is an important incentive for investors, and the need for to protect security of employment.

FIC Recommends:

- Judges must be further educated on the fine line difference between the old and new systems. One of the remaining problems is that the courts still tend to base their interpretation of the provisions of the new law on some legal concepts of the old system which have in fact been abolished.
- Further harmonization of the other labour and related regulations with the new law (new Collective Agreement, social security regulation, etc.).

3.6. Intellectual Property

Former Federal Republic of Yugoslavia (FRY) has enacted a number of regulations outlining guarantees and safeguards for foreign investors in the field of Intellectual Property.

Strong intellectual property right protection is usually one of the prerequisites for foreign investors before transferring their most competitive technologies including trademarks, designs etc. In that respect, FRY has ratified a number of multilateral conventions in order to comply with international standards and provide protection for the intellectual property rights of foreign investors. At the international level, Treaties such as the Madrid Agreement relating to International Registration of Trademarks, the Locarno Agreement relating to International Classification of Industrial Designs and Models have been signed and ratified by Yugoslavia. However, one of the major obstacles in revamping the legal system is the fact that Yugoslavia's status in the WTO is put on hold so the TRIPS Agreement cannot be ratified by Yugoslav legislature, which delays compliance with international requirements.

Amendments to the current regulations are one of the priorities necessary to ensure intellectual property protection. Such legislation is expected to come into force as soon as Yugoslavia becomes a full member of the Council of Europe and the WTO. This is just one of the steps to be taken in raising people's consciousness of respecting intellectual property rights in the same way as any other rights.

Positive Signs:

- There is an increasing awareness that infringement of IP rights must be reduced and therefore breaching parties are facing legal proceedings to stop the breach.
- A special task force has been established to deal with counterfeit products.

FIC Recommends:

- Intellectual property protection is impossible without a well-educated judiciary and administration which would be able to deal this issue. This will require reorganization of the currently existing judicial system by establishing separate departments to deal only with intellectual property registration and infringement. It will also demand creating other institutions to cooperate among themselves in solving the intellectual property rights problems, particularly regarding organized crime and pirate producers, such as: special departments, non-governmental agencies with specific powers of investigation and enforcement. Otherwise, the amendment of regulations without functioning enforcement mechanisms would be somewhat futile.
- There should be measures to prevent infringement of intellectual property rights. This may be done by enforcing existing regulations and introducing a more stringent punishment for intellectual property violations discouraging potential violators to commit such infringements- perhaps by making IP offences a criminal offence.
- Finally, a strong media campaign should be developed in order to influence the wider population on intellectual property issues and raise the sensitivity to such violations.

Chapter 4

Taxation

4.1. Taxation of Corporations

A legal entity is considered resident in Serbia if it is established or has its place of effective management there. Residents are taxed on their worldwide income. Non-residents are taxed only on their Serbian sourced income.

4.1.1. Taxable Persons

A taxable person includes a company registered as a joint stock company, a limited liability company, a socially owned company, a general partnership, a limited partnership as well as any other legal entity generating profit from sale of its products or rendering its services on the market.

4.1.2. Tax Rate and Base

The corporation tax rate is 14%. The taxable base is taxable profit that is determined by adjusting the taxpayer's commercial (accounting) profit, as stated in its profit and loss account, in accordance with the Corporate Income Tax Act.

Significant tax adjustments include:

- Inventories (valued at average cost);
- Depreciation;
- Costs of labour (i.e. wages, salaries, social security) are fully deductible;
- Expenses for health care, scientific, educational, humanitarian, religious, ecological and sport-related purposes are tax-deductible up to 3.5% of gross receipts;
- Expenses for cultural purposes are tax-deductible up to 1.5% of gross receipts;
- Membership fees paid to chambers of commerce and other associations (except political parties) are deductible up to 0.1% of gross receipts;
- Advertising, promotional and business entertaining expenses are tax deductible up to 3% of gross receipts.

4.1.3. Depreciation

Depreciation allowances are granted for tangible fixed assets and intangible long-term assets. Depreciation of fixed assets is recognized as an expense in the tax balance sheet based on the declining-balance or straight-line methods.

4.1.4. Reserves and provisions

Provisions for specific doubtful debts are, according to the Law on Accounting, tax deductible.

4.1.5. Capital Gains and Losses

Capital gains are taxable with other income. Capital gains can be offset against capital losses occurred in the same period. A capital loss can be carried forward for ten years.

4.1.6. Tax Incentives

In November 2002 the Government introduced a range of tax holidays specifically aimed at attracting investors into certain sectors and designated areas and are designed to promote recruitment of new employees. A brief overview of the main incentives follows.

4.1.7. Tax Holidays

Profit earned on the basis of a concession is tax exempt for a period of five years.
There is a ten-year tax holiday for companies investing Dinar 600 mil and employing at least 100 workers.
There is a five-year tax holiday for companies investing Dinar 600,000 and employing a minimum of five workers in underdeveloped regions.

4.1.8. Tax Credits

A tax credit of 100% of gross salaries of newly employed workers for two years.
A tax credit of 20% and for small enterprises 40% for investments in fixed assets, limited to a percentage of tax payable. Any unused tax credit can be carried forward for 10 years.

4.1.9. Exemptions

Non-profit organizations have special rules for tax exemption.
The tax liability for companies employing disabled persons is decreased in proportion to the percentage of such persons to the total number of employees.

4.2. Groups of Companies

4.2.1. Group treatment

Companies are considered a group if one company controls 75% of the shares in another company. A group of companies has the right to tax consolidation if all companies are Serbian resident. Each company files its own tax balance sheet and the parent company files a consolidated tax balance sheet for the whole group. In a consolidated tax balance sheet, losses of one or more companies are offset by the profits of other related companies. Each company is liable to tax proportional to its share in the profit of the whole group.

4.2.2. Thin capitalization

Interest paid to a related entity cannot exceed four times the value of the taxpayer's equity capital and:

- In the case of a loan in Dinars: 110% of the interest rate charged by the NBS on the loans it grants to commercial banks as at 31st December of the previous year, or
- In the case of a loan in a foreign currency: 110% of the interest rate charged by the central bank of the country whose currency is involved on loans it grants to commercial banks as at 31st December of the previous year.

4.2.3. Transfer pricing

A company must separate transactions with associated companies in the tax balance sheet and compare them with arm's length transactions. Credit relations between associated companies are compared with credit conditions in the market. Any unexplained differences are included in the tax base.

4.2.4. Withholding Taxes

Withholding tax at the rate of 20% is levied on dividends and interests and royalties earned by a non-resident company in Serbia.

4.2.5. Assessment and Collection

The tax year in Yugoslavia is the calendar year. Tax returns and tax balance sheets must be filed with the tax authorities by 8 March of the following year. The amount of tax payable is determined by the authorities' notice of assessment, based on a company's tax return and tax balance sheet. A company has eight days from receipt to appeal against the tax authority's decision.

Corporate profit tax is payable in monthly advance installments by the 15th of the following month. The prescription period is five years.

Positive Signs:

- Serbia is trying to develop a market orientated and attractive tax system, reflected in a low tax corporate tax rate and investment incentives
- The process of tax reform is being conducted in a relatively systematic manner over a number of years
- A law on tax procedure and administration has been implemented. This is a major step forward in the introduction of a modern tax system, bringing activities related to determining, collecting and controlling taxes and other public revenue under the authority of the Republican Tax Administration within the Ministry of Finance
- The creation of a large taxpayers unit with the PRA should facilitate greater efficiency when dealing with the tax affairs of large organizations
- The signing of free trade agreements with a number of neighboring countries will encourage regional trade

FIC Recommends:

- Draft legislation should be submitted to FIC / other appropriate forums for comment before being finalized.
- Accounting profit drives tax payable. The introduction of IAS in 2003 and 2004 will have a significant impact on accounting profit, in most cases lowering it. This issue needs to be considered more fully by the Tax Authorities.
- Considerable discretional rights remain with the authorities, resulting in investor hesitancy. For example, the process for obtaining approval for an investment to obtain tax holiday status remains unclear.
- Remedies for the following areas of difficulty
    - Registration of taxpayers takes up to eight weeks, which is far too long. This delays other processes e.g. the opening of bank accounts
    - Inability / difficulty in obtain rulings from the authorities. Furthermore even when obtained, they are not binding.
    - The absence of a fully independent and commercially minded judiciary reduces confidence. There is no reliable forum to challenge Ministry or Agency decisions.
- Simplification of the corporate tax mosaic. The low corporate tax rate can be misleading due to the number of taxes imposed at a local level e.g. public land use charge, company name disclosure, charge for water use and protection, charge for protection and improvement to the environment, mineral raw materials use charge.
- Incentives should be clearly defined, for training staff to encourage development of Serbian expertise.

- The rationale for certain categories of non-deductible expenditure needs to be reconsidered: for example, the limitations regarding advertising expenditure are a major impediment for certain types of business.

4.3. Other Taxes

4.3.1. Property Tax

Property tax is paid in Serbia by all legal entities and individuals who own or have some similar rights (e.g., usufruct, right to use) to real estate, or own registered shares and interests in limited liability companies.

4.3.2. Tax rates

Where the taxpayer keeps books, the property tax on real estate is levied at a flat rate of 0.40%. Property tax on registered shares and interests in limited liability companies is levied at a flat rate of 0.25%.

4.3.3. Inheritance and Gift Tax

Rates of inheritance and gift tax in Serbia are progressive, depending on the relationship between the beneficiary and the deceased/donor and the value of the inheritance or gift. In cases where the taxpayer is in the second order of succession relative to the deceased or donor, the tax rate is 3% in the first band (up to Dinars 200.000) and 5% on the excess amount.

4.3.4. Transfer Tax

Tax on transfers of title to property is payable by a natural person or legal entity who sells rights in relation to real estate, intellectual property, interests in legal entities and securities and the like. The taxable base is the price stated in the contract, or the market value of the property.

4.3.5. Tax rate

The transfer tax rate in Serbia is 5%, except in the case of transfers of interests in a legal entity and securities, where it is 0.3%.

4.3.6. Indirect Taxation

A single-stage sales tax levied at the retail level on supplies of goods is still in force in the FRY. Only cigarettes, alcoholic beverages and coffee are subject to a multi-stage sales tax.

The Federal Value Added Tax Act was adopted in 1999, but its implementation has been postponed for various reasons (e.g. the non-existence of a tax information system both at the federal and republic levels). The implementation of Valued Added Tax is expected on 1st January 2004.

4.3.7. Turnover Tax on Goods

Turnover tax on goods applies to goods for final consumption. The rate is 20%. Taxable turnover includes imports, wastage and goods for own consumption by employees.
The tax base is the:

- Sale price of products, or
- Value of the imported product increased by the amount of customs and other import duties, or
- For products on which excise duties are levied, excise is included in the tax base.

Exemptions exist, inter alias, for:

- Exported products;
- Bread, milk, fresh and frozen vegetables and fruits, fresh meat and fish, eggs;
- Second-hand products sold between domestic individuals;
- Cooking oil, grease and sugar;
- Textbooks and teaching aids. A regulation specifying in greater detail what is regarded as a textbook and teaching aid will be issued by the Ministry responsible for education, science, arts and culture
- Computers, hardware and software. A regulation specifying in greater detail what is regarded as software will be issued by the Ministry responsible for science and technology
- Natural gas delivered to households through the gas distribution network

4.3.8. Turnover Tax on Services

Turnover tax on services applies to all services for which payment must be made. Taxpayers are entities who carry out the services. The tax base is the payment made for the service. The tax rate is 20%.

Exemptions exist for:

- Export services
- Services in the areas of science, education, culture, health and social welfare and sports

4.3.9. Payment requirements

Taxpayers are required to calculate and pay turnover tax as an advance payment within five days of every 15 days in a month.

4.3.10. Retail and Wholesale

Retailers are obliged to calculate and pay turnover tax on goods; as such goods are intended for final consumption. A wholesaler is obliged to calculate turnover tax only on its margin i.e. the difference between sales and purchase price.

4.3.11. Introduction of Fiscal Cash Registers

Persons engaged in the retail sale of products or provision of services to individuals are required, from 1st January 2003, to keep a record of each sale/provision of services using a cash register having a fiscal memory (i.e. a fiscal cash register). In practice the implementation of fiscal cash registers will be staggered throughout 2003. The Government will issue more detailed regulations about keeping sales records using fiscal cash registers and a schedule for the introduction of such registers in due course.

4.3.12. Excise

Excise duties are levied on producers and importers of the following goods:

- Oil derivatives
- Tobacco products
- Alcoholic beverages, alcohol-ethanol
- Coffee
- Soft drinks
- Luxury products (e.g. products containing more than 2% gold, 50% silver, precious stones, furs, goods from reptiles' leather).

4.3.13. Customs

Companies and other legal persons engaged in foreign trade must be registered in the Commercial Court and with the Federal Customs Service. Customs rates vary with the highest tariffs usually applicable to agricultural products. The customs clearance rate is 0,5%.

The Federal Government has drafted a new Customs Law, fully compatible with the EU Customs Law. It will not come into effect before mid-2003.

4.3.14. Free Zones

Free zones may be established and managed by domestic or foreign entities after obtaining authorization from the Federal Government. The value of goods and services exported from the free zone annually must total 50%. The export of goods and services from the zone, the import of goods into the zone, as well as other transactions (business operations with foreign countries, capital investments, and transfer/retransfer of profit/deposits) are not restricted.

4.3.15. Tax on Financial Transactions

All financial transactions within the payment operations, such as transfer order payments, clearing payments, barter trade, endorsement, etc. are taxable at rates varying between 0.22% and 0.41% depending on the amount involved. Certain payments are however tax exempt.

Positive Signs:

- The introduction of Value Added Tax (replacing sales tax) shortly, probably on 1st January 2004
- Relief from sales tax for expenditure on computers, software, textbooks, teaching aids i.e. expenditure which is of genuine benefit to the economy
- Overall the number of taxes has been reduced and consolidated.

FIC Recommends:

- Early announcement of the exact date of Value Added Tax implementation
- Sales tax is extremely burdensome (in some cases there is a tax on tax situation) and often poorly understood by investors: it needs to be replaced by Value Added Tax as soon as possible
- The responsible ministries have authority for determining which computers, books, teaching aids etc are of interest for science, culture and education, and thereby exempt from sales tax. This is another example of where, notwithstanding the introduction of a provision which is positive i.e. removing sales tax from certain items, considerable uncertainty still remains
- The need to reduce the number of goods and services which are exempt from sales tax, prior to the introduction of Value Added Tax. There are too many exceptions.

4.4. Taxation of Individuals: Personal Income Tax

4.4.1. Residents vs. non-Residents

Residents are taxable on their worldwide income, whereas non-residents are only liable to tax on Serbian source income.

Individuals are regarded as Serbian residents if they:

- Have domicile in Serbia, or
- Have their habitual abode in Serbia (i.e. if he stays in Yugoslavia at least 183 days, whether or not consecutively, within a period of 12 months), or
- Have the centre of their business and vital interests in Serbia

4.4.2. Taxation of salaries

The taxable person is the employee, but the employer is responsible for calculating and withholding personal income tax on behalf of its employees. The taxable base is the gross amount including fringe benefits. The tax rate is 14%.

4.4.3. Other Income

Other types of income e.g. royalties, business income, income from agriculture and forestry, investment income, income from immovable property, capital gains and miscellaneous income, are subject to a flat rate tax, which ranges from 10 to 20%, depending on the type of income concerned.

4.4.4. Social security contributions

Social security contributions are calculated and withheld by an employer from the salary paid to an employee. These contributions are payable by employer and employees at equal rates. The rates are as follows:

- Pension and disability insurance 9.80%
- Health insurance 5.95%
- Unemployment insurance 0.55%

4.4.5. Tax on salary fund

This is a monthly tax, payable by the employer, at the rate of 3.5% gross salary.

4.4.6. Annual taxation

Income from all categories is aggregated and, if exceeding a prescribed threshold, is taxed at the (additional) rate of 10%. The current threshold is Dinars 502,050. Advance personal income taxes withheld decrease the tax payable.

4.4.7. Personal allowances

Taxable income may be reduced by allowances for supporting dependent family members (Dinars 50,205 per taxpayer, and Dinars 16,735 per dependent, but not exceeding 50% of taxable income).

4.4.8. Taxation of Expatriates

Benefits
Expatriate-residents of Serbia employed with a resident entity or representative offices of a foreign entity are entitled to a 35% reduction in tax on salaries.

Annual taxation
The income of all categories is aggregated and taxed at the (additional) rate of 10% if exceeding a threshold. At present, the threshold is Dinars 2,342,900.

Filing Requirements
Each taxpayer is required to file a tax return by March 15th of the following year. No extension is allowed. There is no joint tax return filing system in Serbia.

Positive Signs:

- Low rates of tax are an incentive for innovation, hard work and tax compliance
- Tax rates are designed to encourage expatriates to come and work in Serbia and share their knowledge with national staff
- Relative simplicity of the personal tax regime

FIC Recommends:

- Enforcement of rules or their abolition e.g. theoretically fringe benefits are taxable, in practice they are not taxed; while rules of source imply that earnings are taxable if they relate to work performed in Serbia, in practice source tends to be based on where income is paid
- A separate section within the PRA dealing with expatriates to facilitate efficiency. Equally important, this is essential to ensure confidentiality, as many expatriates are reluctant to disclose their earnings in full, due to concern about their personal security. (The latter concern applies equally to Serbian nationals earning significant income.)
- Move from a mentality of net salaries to gross salaries as part of the move to a modern, market orientated economy
- Stricter enforcement of laws as the payment of tax is in many cases voluntary

Chapter 5

Accounting and Auditing

5.1. Accounting

The Accounting Law 1996 regulates the accounting principles and is in force in 2003 for non banking institutions.

The underlying accounting principles for the preparation of financial statements are similar to Generally Accepted Accounting Principles (going concern, consistency, prudence, matching revenues and expenses, accrual accounting).

However, there are still departures from International Accounting Standards on specific accounting matters (inflation accounting, leasing, deferred taxation). In addition, statutory financial statements do not include relevant notes that may help readers better understand the business of a company. Furthermore, with the previous economic isolation, the practice in a large number of enterprises was to avoid disclosure of the full business activity in financial statements.

Companies are obliged to use a chart of accounts, which is a standard grouping in accordance with the law.

All enterprises are required to prepare financial statements and submit them to the authorities twice a year: annual reports for the period ended at 31st December, and interim financial reports for the period ended at 30th June.

Financial reports consists of a Balance Sheet, Income Statement and Annex (supplementary statement for all companies). A Cash Flow Statement and Operating Reports are only required for medium and large enterprises as well as banks and insurance enterprises (financial services companies).

5.2. Auditing

Companies are classified into three categories (small, medium and large) in accordance with the Accounting Law (based on number of employees, revenue and assets).

Only financial services entities and large and medium sized companies are subject to audit, which has to be carried out by a local authorized auditing firm. Medium sized companies with equity of under USD 1 million are exempt from audit requirements in 2002 and 2003. The audit methodology and standards are based on International Standards on Auditing.

Major Differences exist between the practical implementation of Yugoslav Regulations and International Accounting Standards.

These differences refer to the 1996 Accounting Law which is still in force in 2003 for all non-banking institutions or companies.

Accounting Component	Yugoslav Regulations
1.Consolidation	
Basis of Consolidation	Consolidated annual financial statements for entities controlling one or more legal entities incorporate financial statements of the parent company and all of its subsidiaries.
2. Fixed Assets	
Property, plant and equipment	Historical cost less accumulated depreciation subject to revaluation by applying the officially published revaluation coefficients, based on the increase in the retail price index.
Financial leases	There are no specific regulations concerning financial leases
Disposals	Gains or losses from disposals are calculated at revalued book value, and included in P/L. Losses are not directly tax deductible, but can be set off against a capital gain.
Depreciation	Useful lives are typically longer than for IAS Reva luation of depreciation is obligatory
Investments	Generally classified as a long - term investment but may be classified as current assets and recorded at revalued nominal value
3. Financial assets and liabilities	
Financial instruments	Due to underdeveloped financial markets, fair value of financial assets and liabilities is not determined in accordance with IAS 32 and IAS 39
4. Foreign Currency Translation	
Foreign Trading Translation	Unrealized exchange gains and losses are taken to balance sheet in revaluation effect.
5. Inventory	
Accounting for inventory	Use of FIFO, LIFO or weighted average method to determine cost Variances are recorded in both balance sheet and income statement Revaluation authorized
6. Deferred taxation	
Accounting for deferred taxation	Yugoslav tax regulations do not recognize temporary differences. Accordingly, no deferred tax assets or liabilities are recognized.
7. Financial Statements	
Format of Financial statements	There are no requirements for disclosure notes as per GAAP. Accounting policies are not included
Hyperinflation	Non-application of IAS 29: consequently the income statement and balance sheet are not fully adjusted for the effects of inflation and are not presented in terms of the measuring unit current at the end of the reporting period, as required. The balance sheet (only) includes adjustments for the effects of inflation on property, plant and equipment, intangible assets, long-term investments and equity, based on officially published retail price indices, as described above. Parts of the net revaluation gains/losses are reflected in the income statement, the balance being transferred to reserves.

5.3. New Law on Accounting and Auditing

The criteria for company classification are crucial in determining the implications of the new law on accounting and auditing.

Size of Company	Criteria for Classification
Medium	1) Average number of employees: 50 - 250; 2) Annual total income: Euros 2,500,000 - 10,000,000 in Dinar equivalent; 3) Average property value: Euros 1,000,0005,000,000 in Dinar equivalent.
Small	If the value of at least two criteria are lower than mentioned above.
Big	If the value of at least two criteria are higher than mentioned above.

Although several issues require clarification, the major changes include the following:

1. International Accounting Standards
International Accounting Standards are obligatory for legal entities: for banks, effective 1st January 2003 and for all companies from 1st January 2004.

2. Annual Financial Statements
Annual financial statements should comprise:

- balance sheet,
- income statement,
- cash flow statement,
- a report on changes in equity,
- notes to the financial statements.

For small companies, only the balance sheet and income statement are obligatory.

3. Submission of Financial Statements
Only annual financial statements must be prepared (as at 31st December), and they must be submitted to the NBS. The annual financial statements of an entity must be submitted by 28th February, consolidated financial statements by 30th March, and approved financial statements, together with the auditor's opinion, by 30th June. In addition, all companies which require an audit (refer below) must publish their financial statements, together with the auditor's opinion, e.g. on their website.
An exception to the rule (of preparing annual financial statements at 31st December) relates to subsidiaries of foreign companies whose financial year differs from the calendar year. They may prepare and submit financial statements coterminous with the financial year of the parent. However approval from the Ministry of Finance is obligatory.

Another exception relates to entities undergoing a change of status e.g. merger, liquidation, bankruptcy. Such entities are required to prepare financial statements at the date the procedure concerned is completed.

4. Audit Requirements
The audit of annual financial statements for big and medium sized companies is obligatory, although the requirement for medium companies is effective from January 1st, 2004. Rotation of auditors of medium-sized companies is compulsory after five years, while for big companies, rotation is necessary after three years.

5. Chart of Accounts and Bookkeepers
Records must be kept in accordance with the prescribed chart of accounts. It is not clear at this time if a new chart of accounts is to be released or the existing chart of accounts amended.
A person who has passed professional exams must keep books of account. National standards will define training conditions and professional examinations.

6. Requirements for Preserving Records

Salary records which contain important information about employees must be kept permanently; financial statements for 50 years; the general ledger for 10 years; and supporting documentation for five years.

Financial institutions are obliged to keep data on payment clearance for five years.

Positive Signs:

- The fast implementation of International Accounting Standards is a key step towards transparency and will certainly facilitate foreign investment
- The implementation of International Accounting Standards will position Serbia ahead of other countries in the region in regard to the accounting framework

FIC Recommends:

- Implementing International Accounting Standards implies and requires significant training and a high degree of knowledge which is not in place in Serbia at present. Tax authorities, finance department staff and professional organizations lack widespread knowledge of International Accounting Standards
- The impact of applying International Accounting Standards on taxable profit needs to be addressed as a matter of urgency, bearing in mind that taxable income is largely based on accounting profit
- The prescribed format of statutory financial statements and the chart of accounts needs to be revised to comply with International Accounting Standards
- The role and independence of auditors needs to be debated and clarified by the relevant authorities

Chapter 6

Labour, Public Administration and Bureaucracy

6.1. Availability of labour

The Yugoslav labour force is skilled and well trained. This applies particularly to those under 45 years of age. Another important feature is that the labour force is inexpensive relative to many European countries, although there are indications that this is likely to change as salary expectations rise.

However, due to the crisis of the past decade, the unemployment rate is high, estimated to be about 30%. Accurate statistics on unemployment are, however, difficult to obtain as a large proportion of the population works in the grey market.

The Labour Law provides that an employee has to be over 15 years of age and be medically fit to work. Special requirements may be determined at the discretion of the employer. The labour relationship is established by an employment contract concluded between the employer and the employee.

6.2. Working Hours

Full time employment is 40 hours in a week. Overtime cannot last longer than 4 hours per day, and not more than 240 hours per year.

6.3. Social Security

The Yugoslav social security system encompasses retirement, health and unemployment rights and obligations. All employees of domestic companies are within this system. Foreign citizens employed by companies that are partly or wholly foreign owned are within the system, unless there is an applicable social security treaty.

Social security contributions are calculated and withheld by an employer from the remuneration paid to an employee. These contributions are payable by employer and employees at equal rates. The portion of social security contributions payable by an employer is treated as an operating cost, while the portion payable by an employee is part of his gross wage.

The social contribution calculation base is gross salary. The minimum base for the calculation of social security contributions depends on the level of the employee's qualifications and is adjusted quarterly in accordance with the growth of average salaries. The maximum base for the calculation of social security contributions is five times the average gross salary in Serbia. The social security contributions were reduced so that they are now some of the most competitive rates in the region. However, as healthcare, unemployment and pension funds remain under funded; employees see little for their money.

Former FR Yugoslavia has concluded several multilateral treaties on social security as well as bilateral treaties with Austria, Belgium, Bulgaria, the United Kingdom, Denmark, Egypt, Italy,

Libya, Luxemburg, Hungary, Germany, Norway, Panama, Poland, Romania, France, the Netherlands, the Czech Republic, Switzerland and Sweden.

6.4. Expatriates

Work permits
Foreign citizens are required to hold work permits issued by the Serbian Agency for Employment.

Foreign citizens who have obtained permanent residence permits and work permits are entitled to work full time. Those who have temporary residence in Yugoslavia have to obtain approval for full time employment. In this case, the employer is obliged to submit a request explaining reasons for employing a foreign citizen. No work permit is required if the foreigner is to be employed for the purpose of performing duties set out in a foreign investment agreement.

Work visas
A business visa is issued to an expatriate:

- Intending to conduct activities in the area of foreign investment or international trade, according to domestic law, or
- Not requiring a work permit to conclude an employment contract with a domestic entity.

A business visa can be issued for the entire period of conducting business, but it cannot last longer than the petitioner's passport. It is usually issued for six months.

Expatriates with the appropriate visa are entitled to stay in the Serbia for up to three months without claiming temporary residence.

An individual with a transit visa is entitled to stay for up to seven days. Persons with a business visa are entitled to stay as long as the business visa lasts. Visas can be rejected or revoked by the Ministry of Internal Affairs and no reason needs to be given. Neither appeal nor any other legal remedy is allowed against such a decision.

Residence permits
An expatriate who wishes to be employed by a representative office or by a local company has to submit an application for a residence permit. Before the representative office or company is established, the residence permit is initially issued for six months. After the registration procedure is complete, an expatriate will have the right to apply for a business visa which is valid for one year. Personal documents of the expatriate are presented to the Ministry of Internal Affairs (Belgrade Police/ Department for expatriates). Submission of these documents and obtaining a residence permit has to be done by the expatriate personally. The procedure takes approximately 30 days. All visitors to the country are obliged to present themselves for registration within 72 hours of arrival.

Positive Signs:

- There is a growing awareness within the Ministries dealing with foreign investors that bureaucratic barriers and red-tape results in time consuming and frustrating first hand experience doing business in the country.

FIC Recommends:

- One Ministry or national coordinator should be required to overhaul and guide reform with respect to the time, documentation required and efficiency of the institutions dealing with expatriate investors. This may be done by establishing a fast track department to deal only with business expatriates. There must be good communication with the relevant Ministry or organization dealing with the investment.

The Financial sector of Serbia and Montenegro has suffered great damage in the past decade. Thus, generating an overview of all still unresolved issues within the financial sector requires great effort and time. This is why in the first edition of the White Book FIC devoted attention only to several important points, such as the functioning of the new payment system, loan loss provisioning, legal lending limit, syndicated lending, mortgage lending and leasing.

Chapter 7

Financial Sector

7.1. Payments system

The new Law on payments transactions is in effect since the beginning of 2003. The level of liberalization of the payments system is one of the important elements of the overall environment which can attract foreign investors into the country.
The Law, as it was published, besides regulating activities concerning payments transactions, also regulates all rights and obligations of Banks and their clients. Even though the text of this Law is very well written, and its content quite precise and thorough, its application in practice has proved somewhat problematic.

Positive signs:

- The vast majority of the banks operating in Serbia have made a considerable effort to adapt to the new demands, and have taken great steps towards improving its infrastructure.
- The Government has proved its determination to support and apply the new Law, despite the fact that it had many reasons to postpone its implementation.

FIC Recommends:

- Since the burden of operating payment transactions now falls on Banks, the Government must play the very important role of providing them with the knowledge and expertise that existed within the old SDK/ZOP system. This will not only make the banks more efficient and faster, but it will also provide for a more unified way of operating on a daily basis. In other words, the Government must get involved in formulating the tactics of transition to the new system, in addition to the strategy that it has formulated when the law was passed. This can be achieved by passing bylaws which would regulate the specific daily operational activities, as problems arise.
- The Government's determination to implement the law should be supported with measures which will ensure the efficient functioning of all agencies that are involved in the payment transactions (the Central Clearing of Payments, the Committee for enforced payments etc.)
- A new procedure must be allowed to function with as much flexibility and safety at the same time, as possible.

7.2. Banking Legislation

The banking legislation is complex and voluminous. A fully fledged analysis of such legislation would require ample time and space. Thus, we have selected four particular topics, which, we believe, can significantly affect not only the banking sector, but the whole economy.

7.2.1. Loan loss provisioning

The key issue in this respect relates to the classification of assets with respect to assessment of potential losses in relation to credit risk.

According to the Decision on criteria for classification of balance sheet assets and off-balance sheet items, the classification of assets as well as accompanying rules that are applied to assessment of potential losses may lead to serious negative consequences for the entire banking sector.

This classification is defined in such a way that:

- The borrower's historical financial performance is set as the key criterion for asset classification.
- Set of collateral instruments that can be applied towards reduction of provisioning basis is limited, so that it does not allow for a reduction of the basis for loss provisioning.

The combination of the two points stated above will lead to a massive provisioning in the commercial banking sector as of end 2002. This would significantly decrease lending capacity of the Serbian banking sector.

In many situations these criteria are misleading and cannot be taken as reliable indicators for the credit risk of the lending bank.

This would be the case:

- Where the borrower is owned by a financially strong company or belongs to a financially strong group of companies and the support of this company or group can be expected.
- Where there is a financially strong owner which is contractually committed to the borrower (e.g. through an investment commitment and/or an ownership clause in a privatization agreement)
- Where a financially strong owner or ownership group demonstrates its commitment through a letter of comfort or even a corporate guarantee.
- Where a bank guarantee has been issued by a reputable bank which is resident in an OECD country and holds a satisfactory external rating
- Where reliable and financially strong companies start a business which normally results in a loss during a start-up phase.
- Where companies are in a turn-around situation and need bank financing to restructure their activities into a business.

According to the current interpretation of the Decision in all the cases listed above a provision of 50% of the outstanding loan would have to be created by the lender making any lending under such circumstances very unattractive. In a country which is still at the beginning of a transition period and has ambitious plans for privatization this presets serious obstacles for lending to privatized companies, start-up companies and companies in a turn-around situation are not only a serious problem for the banking industry but for the entire economy.

In the near future, as new foreign direct investments materialize, the situation may worsen. Many of the foreign companies that come to Serbia and establish a subsidiary will typically experience start-up losses. According to the Decision, loans to such companies would be treated as the second-worst risk category and would require 50% provisioning, thus making lending activity prohibitively expensive. This would ultimately lead to off-shore banking, which is certainly not in the interests of the state, local banks and companies alike.

Positive signs:

- The authorities further strengthened prudential norms and regulations, bringing them up closer to EU standards.

FIC Recommends:

We strongly suggest that the Decision covering the loan loss provisioning is re-considered and amended to the effect that:

- Provisioning should be mainly determined by the historical payment behavior of the borrower;

- The ownership structure of a borrower should be taken into account;
- Letters of comfort and corporate guarantees should be accepted as valuable collateral in the case when satisfactory financial standing of the issuing company can be demonstrated;
- Bank guarantees of non-OECD countries are accepted as valuable collateral in case the issuing bank (or banking group) holds a minimum rating of BBB- by Standard & Poor's/Fitch or a minimum rating of Baa3 by Moody's.

We strongly believe that the relevant decision that regulates the classification of assets should be based on the repayment behavior of the client. Moreover, if adequate collateral exists, like that described above, a placement to a client should be relaxed from significant provisioning requirements. Only in absence of adequate collateral, such placement should be subject to categorization based on: (i) assessment of the borrower's financial position, (ii) the borrower's capacity to ensure adequate cash flows, (iii) borrower's repayment track record, (iv)likelihood of loss making, and other criteria, as it is stipulated in existing legislation.

7.2.2. Legal lending limit

In accordance with the provisions of the Law on banks and other financial organizations on adjusting of the scope of operations of banks, it is stipulated that the largest possible loan shall be understood to mean a loan, or some other claim or guarantee amounting altogether up to 25% of the bank's liable capital.

FIC Recommends:

- It is our proposition that the corresponding Decision on application of articles no. 26 and 27 of the Law is amended by extension of the legal lending limit up to 100% of the bank's capital, under the condition that the exposure of the Bank is covered by the unconditional payment guarantee issued by a prime foreign bank. Because the loan exposure should not affect the risk position of the local bank, the bank that is issuing the guarantee should possess a certain investment grade (to be defined by the National Bank of Serbia) granted by an international recognized rating agencies, like Standard & Poor's / Fitch or Moody's and should be headquartered in an OECD country. This would give assurance so that that the overall risk position within the banking industry would not deteriorate and that the local lending power of the Serbian banking industry would increase. This is of utmost importance as we do expect more Foreign Investors coming to Serbia, who would like to finance parts of their investment also locally and not just off-shore. That is the main reason why the majority of the countries in CEE have accepted this regulation
- Knowing that current legislation treats such securities as a deductible item from the legal lending limit, we believe that if there is an existent pledge agreement between a first class foreign bank and a local bank, whereby such foreign bank pledged state securities in favor of the local bank, then the value of the pledged securities should be used to extend the legal lending limit of the local bank. Experiences in the region show that this type of collateral is applied in several countries, like Hungary, Slovakia and the Czech Republic.

7.2.3 Syndicated lending

The past experience of local banks in syndicated lending is very limited: Local banks and the companies had experience in syndication as the borrowers, in case of disclosed (open) participation only. However, local banks did not participate in granting of syndicated loans.

At present, local banks are willing and able, and have interest, not only to be in the position of the borrower, but also to participate in the international syndicated loans.
Currently, the legislation does not forbid local banks to participate in the international syndicated loans, irrespective of the form of participation: disclosed, silent or sub-participation, but the transaction can not be effectuated because it is not explicitly anticipated.

Current regulations

Foreign Exchange Law prescribes that capital transaction between residents and non-residents are free, except if otherwise provided for by the Law. Limitations are indicated in Articles 12 - 19. The Foreign Exchange Law does not refer (explicitly or implicitly) to participation of residents in the international syndicated loans.
Foreign Credit Transactions Law does not prohibit granting and receiving international loans by the local banks. On the other hand, it does not recognize the Participation and Sub-participation Agreement because they do not have standard elements of the credit transaction - "borrower" - "creditor" relation.

The problem is reflected in the following facts:

- Restrictive interpretation of the Foreign Credit Transactions Law;
- Non compliance of the Foreign Credit Transactions Law (1992) with the Foreign Exchange Law (2002);
- No transfer of funds abroad, under any capital transaction, is possible if no code is determined for the same, regardless the fact that such capital transaction is not prohibited by the Law;
- Insufficient range of transactions listed in Book of Codes comparing to the range of operations permitted by the Foreign Exchange Law.

FIC Recommends:

- NBS should exercise more flexible approach in interpretation of the Foreign Credit Transactions Law taking into consideration:
  (a) Solutions already included in the Foreign Exchange Law
  (b) Modern (new) forms of international loan products
  (c) Interests of the borrowers and the banks - creditors
- NBS should supplement bylaws where permissible, i.e. supplement the Book of Codes, containing the basis for collection, payments and transfer under current and capital transactions, with the following type of activity:

"Participation, purchase or sale of the participation in the syndicated loan"

The first modification and amendment to the Law should provide possibility to the local banks to be Lead Managers and Underwriters in syndicated loans granted to foreign or local borrowers.

7.2.4. Mortgage Lending

Current status - Present obstacles for long - term and efficient development and growth

A non - commercial orientation for the enforcement of contracts based on ownership rights is still very present, which fact inevitably constrains development of sustainable mortgage financing. That fact has, as well as the number of others following therewith, deterred the development of a market for mortgage finance and, along with it, of entire institutional infrastructure and related funding.

Mortgage ("hipoteka" in Serbian)
Article 64 of the governing federal law, regulating the basics of the ownership title relations, provides for as follows: *"Based on a legal deed or a court decision, a mortgage gets instituted by an inscription in a public book or in other appropriate manner as defined by law".*

A condition precedent for granting a loan secured by a mortgage is, therefore, present in the Yugoslav (i.e. Serbian) legislation. The practice at the local market is, on the other hand, different. It is well known that approximatelly 80% of real estates in Serbia is not appropriatelly registered in public books. Even in the case that certain real estate is registered, it is not unusual that there is a discrepancy between the real facts and the data contained in the Register. Such a situation, beyond any doubt, represents the basic obstacle for the further development of the subject market. Without clear ownership, there is no clarity with regard to claims. The absence of clarity on these issues makes it riskier and more costly for lenders or investors to assume exposure in housing or commercial real estate.

It must be additionally noted that, pursuant to the existing legislation, there is no possibility for instituting so called "mortgage over project", which fact aggravates financing (and, consequently, development) of construction ventures.

Law on Enforcement Procedure

The new version of the relevant law was adopted in June 2000 to improve collection capacity for banks and other creditors as an incentive to increase lending. Changes made, as compared to the previous version from 1978, were designed to reverse the traditional bias in favor of debtors.

The practice, on the other hand, shows that the above - mentioned bias is still quite influential. Not desiring to unnecessarily deal here with provisions of The Law on Enforcement Procedure, may we just aver that the practice has shown up to now that a creditor, who had finally fought his way to execution procedure, is not even in this procedure, which should actually be purely a technical one, properly protected. The subject law's provisions, not really transparent and adapted to every day's life, followed by inactive and inefficient "eagerness" of courts' executioners and support of the authorities (primarily the police) that can be obtained extremely hard as well as with substantial resistance of a debtor, draw finally to a conclusion that the real value of a mortgage as a security instrument could be, also from this point of view, challenged.

Positive signs:

With the change of government by the end of 2000, Serbia's general and economic policy has turned to achieving the principles of market economy. One of the aspects of this new approach has been also shown in the field of setting out some basic preconditions for the establishment and further development of a mortgage financing local market. Activities, undertaken in this regard by the competent governmental bodies and certain highly recognized international expert organizations gave first results in late summer 2002 (e.g. The National Mortgage Loans Insurance Corporation is expected to be established soon, work on drafting The Mortgage Law is undergoing, official expectation is that the vast majority of real estate will be registered within a period of 3 years in compliance with recently passed law, which goal is thorough and efficient coverage of real estates in Serbia etc.).

FIC Recommends:

The above - stated suggests that further major changes are required if mortgage financing for residential and commercial properties is to be more sustainable and to have general positive influence in the sense of encouraging investors to enter the local market more easily as well as in the sense of further necessary development of a mortgage market, especially its infrastructure. These changes would particularly reflect in the following:

- Passing of new, modern Mortgage Law
- Appropriate amendments / additions to the Law on Enforcement Procedure in the sense of providing, among other things, for the enforcement procedure of a mortgage (foreclosure of a mortgage loan) - as already proposed by the competent ministry - **to last not longer than 2 weeks,** introduction, in the form of a law or via the existing law, of specific institution(s) that would enable efficient and undisturbed realization of an enforcement procedure etc.
- The final recognition and regulation by law and, therefore, the affirmation of a **fiduciary transfer of title,** would have, *inter alia*, very positive effect to this field of economic and financial activities.
- introduction (in a form of law) of *The Provisional Register of Mortgages*, which would (meanwhile - until completion of land registries) fully secure creditors that the mortgage, once inscribed in this Register in course of a procedure set up by the law, cannot be challenged by any other third party at any time until a mortgage loan is repaid or foreclosed. Such a Register would not, in any sense, imply an issue of the ownership title over the subject real estate. A possibility (but minimized through a procedure for an inscription of a mortgage in this Register) that a mortgage debtor may turn not to be the one who was entitled to dispose with the subject property (bearing particularly in mind the question of the upcoming denationalization - restitution) would be, in any case, covered with the state guarantee for indemnification yet to be confirmed by the long expected law. Our opinion is that the introduction of this Register would accelerate the development of a mortgage market in general and be of a benefit for the Authorities in their efforts to finally register real estates throughout Serbia by gradually integrating its data into the relevant cadastre.

7.3. Leasing

Positive signs:

- The draft on the Law of Financial Leasing is a very courageous and forward looking step in the right direction. But we think there are some points mentioned still to improve and to regulate in order to attract foreign investors to operate in Serbia.
- The legal protection of the lessee by Serbian legislation is doubtless important but should not be done against the justified interests of the lessor.

Nevertheless there are some points which must be highlighted.

7.3.1. Operating Leasing and Financial Leasing

In our point of view the missing distinction between the legal institutions Operating Leasing and Financial Leasing is a serious shortfall of this draft version.

It is the official opinion of the Serbian legislators that a new Leasing Act would only have to address Financial Leasing as a legal subject. It is the official point of view that other forms of leasing are already covered by general regulations of Serbian civil law.

From the standpoint of legal clarity we cannot follow this point of view. In order to be sure of all legal implications which could follow the application of a particular form of leasing in daily business life it is crucial to define the institute of Operating Leasing according to the principles of the International Accounting Standards (IAS No. 17) and US Generally Accepted Accounting Principles (US-GAAP No. 13).

7.3.2. Lessor, Lessee, Supplier and leasing contract

The present draft seems to stipulate certain premises for the person of the lessor and the lessee as well as for the lease relationship in general which must be considered a problem for foreign investors and the development of a prospering leasing business in Serbia.

The lessor has to acquire a certain license from the competent court (Art. 6) in order to be permitted to carry on some leasing businesses. The wording of the draft is not entirely clear whether the foreign leasing company has to apply for a license or whether a simple registration is sufficient. Additionally the lessor's company must have equity of at least EURO 100.000,00 (instead of USD 5.000,00 equity, which a normal company with limited liability must raise) and must be founded according to the Serbian corporate law (Article 12).

The lessee has to be commercial company (Article 13). Non-for-profit organisations as well as private customers seem to be excluded from the application range of this draft.

The legal wording "legally sanctioned service life" (Article 4) is not explained any further in the translated draft and seems to be a translation mistake. In the authentic Serbian draft the Serbian word for "amortization validity period" is used.

The legal limitation (Article 4) of the duration (80% of the legally sanctioned service life) of the leasing contract must be considered a serious limitation of the entrepreneurial freedom for a leasing company.

According to this draft the leasing asset must be "movable and durable" (Article 10). Whether this paragraph also covers buildings as leasing assets is therefore arguable. In the enumeration at the end of the paragraph "plants" are mentioned. In the authentic version the Serbian word "postrojenja" is used. The correct English translation of this word is not "plant" but "machinery"!

The contract of delivery (Art. 8) is said "is the contract between the lessor and the supplier pursuant to which the lessor acquires the ownership title…" This regulation limits property leasing for there is no supplier if a building is be constructed by the leasing company itself or by a third party in behalf on the leasing company. Also "sale and lease back" constructions are not possible under these conditions.
The draft requires the leasing contract itself to be highly formalized (Article 5). There are plenty of

formal demands which have to be included in the leasing contract. It would be highly desirable if the terms of contract were not so restricted by law.

7.3.3. Cancellation of the contract

The lessor is given the right to cancel the contract if the first payment is not paid. If the first payment is done the lessor has been given the right to cancel the contract if the outstanding sum reaches the amount of one quarter of the total lease payment.

In accordance with the legal systems of the member states of the EU it would be preferable if the draft stipulated a right to cancellation if the lessee failed to pay two following monthly leasing payments.

7.3.4. Tax adaptation to the EU legislation and tax incentives

The Serbian legislation should intend to establish a certain legal infrastructure for foreign investors which have the capability to provide security and predictability in legal as well as in economical matters. Also tax incentives are always necessary to signal foreign companies to invest abroad.

One of the most important points to state relevant to property leasing is the necessity to avoid double taxation. If Serbian tax laws charge sales tax for all services relating to the construction of a building and additionally sales tax has to be paid for leasing payments a leasing company cannot provide competitive offers especially if compared to bank loans and mortgages.

From PricewaterhouseCoopers we received the information that from the date of January 11th, 2003 some services "relating to the leasing of business and other premises, provided by an individual/citizen who is not engaged in a registered business" are exempted from Sales tax. It is doubtful whether this includes services from or for foreign leasing companies even if they have subsidiaries in Serbia. Even if, we strongly suggest the introduction of a VAT system.

FIC Recommends:

- A Value Added Tax system based on the EU Value Added Tax system is indispensable for frictionless and smooth economic processes. There are certain considerations to change the relevant tax legislation and to turn the present sales tax into a modern Value Added Tax system (see Proposed Changes and Amendments to the Law on Sales in Reference to the Law on Financial Leasing and the paragraph above), but corresponding change of the Law on Sales Tax has not yet taken place.
- In general adaptation of Serbian tax laws to the legal system of the EU is crucial for the Serbian attempts to intensify the trade with foreign countries in general as well as for establishing a flourishing leasing business in Serbia in particular.
- We also refer to our proposal paper *Suggested Local Tax Incentives for Lease financing in the Federal Republic of Yugoslavia* which we already have put forward. In this draft we mentioned a spectrum of tax incentives which are crucial prerequisites for foreign investors. Among those are important measures, such as the introduction of tax allowances and depreciation in the range of 4 to 5% which is tax deductible.

Above all, the adaptation of the Serbian tax legislation to the EU tax law system has to have pre-eminence in the consideration of the Serbian legislators. These ambitions have to be accompanied by tax incentives in Serbian tax laws having the potential to attract foreign capital. It is therefore not only important to change and adapt the existing legal system, but also ensure that the changes are durable (for at least five years). A permanent change of the legal system will upset foreign investors as well it will destroy the business location.

As long Serbia has not introduced a modern Value Added Tax-system replacing the Serbian Sales tax, it is very doubtful whether foreign investors would even contemplate significant investments in Serbia. We therefore strongly suggest to introducing Value Added Tax from July 2003 as has been repeatedly promised by Serbian authorities.
It is important to include some observations on the Double Tax Treaty between former FR Yugoslavia and Austria.

The Double Tax Treaty between Yugoslavia - its successor states Serbia and Montenegro respectively - and Austria is currently under negotiation. The legal bodies in Austria and Serbia are now invited to make their comments.

We think that in order to establish a prospering leasing industry it is especially important that the Serbian withholding tax of 10% is not included in the official Double Tax Treaty. From the viewpoint of an Austrian investor this tax must be considered a competitive disadvantage. So for example compared with the Germany/Yugoslavia treaty (withholding tax 0%) the Austrian investor is discriminated against.

7.4. Insurance

The instability of the insurance sector in Serbia can be attributed to a wide range of microeconomic and institutional failings. A particular case in this regard is that of state-owned companies, where managers are guided by objectives that are not compatible with sound financial practices, while at the same time they are shielded from any external discipline. Weaknesses in the legal framework compound the problems of lax management and weak corporate governance.

In the absence of effective market discipline, the entire burden of external control falls on insurance supervisors who may not have the requisite capacity.

The strengthening of the regulation and supervision framework in parallel with the slow and cautious introduction of liberalization measures is essential for improving the efficiency of the insurance market in Serbia. The crucial issue for a robust insurance system is the development of capable, professional personnel of insurers and supervisors.

Positive signs:

The Current Law is being reassessed and is likely to undergo significant changes to match the EU standards.

FIC Recommends:

- Availability of reliable basic data is essential for effective market discipline. In Serbia, an insurance company does not have enough past insurance policies to create a reliable data basis or a data collecting system itself has not yet been properly established. Thus the collection of claims data through cooperation of insurers should be encouraged. The insurance supervisory authorities should also establish a reliable claims database that will help insurers and supervisors confirm the right price for various categories of products.
- Insurance legislation and reliable information can play their proper role only if enforcement body i.e., an insurance supervisory body is established and functions effectively. Therefore, the insurance supervisory authority should:
    a) have the power to license insurance companies,
    b) apply prudent regulations, conduct consolidated supervision,
    c) obtain and independently verify relevant information,
    d) engage in remedial action and execute portfolio transfer,
    e) apply sanctions against insurance companies which do not follow the recommendations and injunctions of the supervisory authorities Be independent from both political authorities and controlled companies in the daily execution of supervisory tasks and be accountable in the use of its powers and resources to pursue clearly defined objectives;
    f) Have broad and ample knowledge and experience ranging from actuarial science to contract law drawn from wide experience;
    g) Have a reliable and stable source of funding to safeguard its independence and effectiveness;
    h) Have the powers and sufficient resources to co-operate and exchange information with other authorities both at home and abroad thereby supporting consolidated supervision; and
    i) Establish an employment system to hire, train and maintain a professionally qualified staff. At the same time, the insurance supervisory authority must be bound

to strict professional secrecy and the legislation must exclude any arbitrary intervention of the administration.

- Except in the cases stipulated in law, the insurance supervisor may under no circumstances interfere in the management of insurance companies. The company's management is the only party liable for the decision it makes within the framework of the mandate conferred upon it by the owners of the company.
- The supervisory authority should establish good cooperation and undertake co-ordinated schemes with other related government bodies or insurance institutions, such as ministries, tax offices or insurance guaranteed funds so that the given tasks are properly carried out.
- The insurance industry should be encouraged to set up private mechanisms and institutions for the application of business guidelines and a code of conduct to limit detrimental practices. Self-regulatory principles and organizations, including professional bodies can be a useful complement to the public supervisory structure. However, supervisory authorities need to scrutinize such arrangements in order to ensure that they promote effective market functioning.
- It is important to improve the quality, timeliness and relevance of standards for disclosure of key information needed for credit and investment decisions in the interest of stakeholders (interested parties). Ensuring information disclosure is also essential for consumers to be able to select appropriate insurance products from the right insurance company. The most important information concerns the financial condition of an insurance company, the nature of its insurance products and the character of an insurance intermediary.
- Sufficiently strict licensing criteria should in particular govern the establishment of insurance companies. Examination of the nature and adequacy of the financial resources of insurance companies through analysis of business plans and the requirement for a relevant minimum level of capital deserves particular consideration. The supervisor should also consider the suitability of owners, directors and/or senior management. The insurance supervisor should also review changes in the control of companies and establish clear requirements to be met when a change in control occurs. These may be the same as or similar to the requirements which apply in granting a license.
- The underwriting of insurance risks should be restricted to insurance companies, which may transact insurance operations only. Life and non-life insurance operations should be separated, so that one activity cannot be required to support the other. Reinsurance companies and direct insurance companies should also be separated at the initial stage in emerging market economies.
- Insurance supervision should be exercised over the entire operations of the insurance company undergoing control and should involve various aspects, such as moral, legal, technical and financial. The insurance supervisor should in particular ensure that insurance companies are observing the regulations applicable to insurance. More specifically, the insurance supervisor should ensure that insurance companies:
  (1) meet the contractual commitments made toward the insured (legal control);
  (2) are at all times in a sound financial position so as to meet their commitments.

7.5. Pension and social reform

Social spending in Serbia is high but inefficiently administered. According to preliminary World Bank estimates, about 12 % of former FRY residents (almost double the number in 1990) and one quarter of 650,000 refugees and internally displaced persons live in absolute poverty. The majority of the poor live close to the poverty line.

This does not appear to have been reflected fully in available social indicators (e.g. life expectancy and infant mortality), which are still favorable compared to averages for neighboring Balkan countries, but generally worse by than the other transition countries in central Europe. However, the poor quality of healthcare, inadequate targeting of social benefits, and high budgetary cost all point out the urgent need of reforming the system of social services.

Positive signs:

Important pension reforms were adopted recently in Serbia. In December 2001, the federal parliament approved changes to the pension law whereby:

- The retirement age was raised three years for both men and women (to 63 and 58 years, respectively);
- The pension indexation formula was shifted from wages to the arithmetic average of prices and wages (the so-called "Swiss model"), while the indexation frequency was reduced from monthly to quarterly;
- The minimum pension was set at the equivalent of 20 % of the gross average wage (compared to 20-40 % previously).

Given the large number of benefits, the complexity of finances and delivery, and the multiplicity of eligibility criteria, the overall social welfare in Serbia is generally inadequately targeted and hence both inequitable and unduly costly. With a view to addressing these problems, the authorities - with World Bank assistance - intend to begin an overhaul of the system, building on a household survey and related poverty analysis work now underway. Designing a nation-wide comprehensive welfare provision framework with unified eligibility criteria, and providing incentives in the welfare system for re-employment and retraining will be key measures.

Further reform measures are envisaged over the next three years to put the pension fund finances on a sustainable path, including a modification of the benefit formula and valorization rule to reduce the redistribution element and increase the linkage between benefits and contributions, a tightening of the eligibility requirements for disability pensions, and a further reduction / elimination of non-pension social benefit paid by pension funds.

FIC Recommends:

In order to strengthen retirement income security in Serbia and enhance a critical engine of economic growth, the government policies must adhere to the following four principles:

1) Provide stable rules that encourage the voluntary creation and maintenance of soundly financed employer-sponsored plans;
2) Introduce efficient means for individuals to acquire adequate retirement income;
3) Support the dynamic needs of employers;
4) Encourage capital formation.

The following strategies for action will implement the policy principles discussed in the previous section:

(1) Introduce the government's commitment to voluntary employment-based retirement programs; Retirement security will founder in the future without a government commitment to voluntary employment-based retirement programs. That commitment must include a sound fiscal policy, specific financial incentives, and effective but unobtrusive government regulation. The components of such a commitment include a determination to:

- Encourage the Creation of the Voluntary, Market-Based Retirement System. Although opportunities for individual savings must be increased, the most efficient and cost-effective savings is likely to continue to occur in-group plans established through employers.
- Provide Beneficial Tax Treatment for Savings Under Employer Retirement Plans. It is recommended to apply the EET tax code for the treatment of Employer Retirement Plans. This is to comply with the most common and preferable tax treatment in the region and the EU.
- Determine the Future of Social Security. Establishing and adequately planning of clear and attainable goals for retirement income provided through Social Security. This will allow employees and employers to make effective judgments about the types of programs they can afford and will provide individuals with a sound basis on which to determine the amount of savings they need to retire at a desired income level.
- Coordinate Pension Benefits with Social Security Benefits.
- Adopt a Low-Inflation Fiscal Policy. Future retirees will have to rely more on individual savings for their retirement income. Such savings can easily be nullified by periods of high inflation. Increases in life expectancy exacerbate this problem. It will be critically important for the long-term well being of future retirees that the government pursues a low-inflation economic policy.
- Avoid Politically Appealing But Ineffective Proposals to Expand Coverage. The government's energy and scarce resources will be better spent on increasing its understanding

of how plans operate, what motivates an employer to offer a plan, and what the true long-term costs of a plan are.

- Provide a Long-Term Policy Focus. The government should create a long-term focus and stable regulatory environment that comes from the highest levels and is effectively coordinated throughout the Executive Branch. The government has many ways to pursue this objective. A Business Conference on Retirement could be convened regularly to coordinate policy and make recommendations cutting across lines. A special committee could be created under the relevant Ministry or parliament.

(2) Educate the Serbian worker. Future retirees must take more responsibility than in the past for accumulating the assets they need to retire. Education is central to that development. Surveys indicate that workers seldom are aware of the amount of savings they need to accumulate to reach their retirement goals.

- Provide More Opportunity to Use Modern Technology in Disseminating Information to Employees About Their Plans and in Providing Employee Education. Use of modern technology is key in developing successful education programs. Detailed paper descriptions required to be provided to employees often are not read now and are less likely to be read or understood in the future when most employees will be more comfortable seeking information through Media or computer technology. Modern Media, computer and telephone response systems are far superior in providing accurate, understandable information.
- Pursue National Informational Campaigns. Such campaigns have been proved effective in other countries in changing behavior (e.g., campaigns involving purchasing savings bonds, using seat belts, and stopping smoking).
- Start Savings Education Campaigns Early. A more concerted effort to encourage savings among all age groups is likely to result in increased retirement savings. The habit of saving will be most successfully established if it is begun early. Savings education campaigns targeted at school-age children will have an impact on those youths and their families.

Chapter 8

Other Sectors

8.1. Real estate

8.1.1. Land and Construction

8.1.1.1. Land ownership

The Constitution of the Republic of Serbia states that urban building land is either state or publicly owned. According to the 1997 Development Land Act, urban building land is exclusively owned by the state. The land is developed through the construction of buildings according to plans and regulations. The municipality council is responsible for land management and the provision of utility installations.

The right of use for urban land can be awarded to the bidder who offers the best price at auction. In the total price there is the amount for the right of use of the urban land and servicing.

If the owner of the building sells the building, the right to use the land is sold with it.
For the duration of the right of use, apart from paying for servicing of the land, the owner pays compensation for the use of urban land. The amount of this compensation is determined by local authorities.

The state ownership of urban land creates major problems. Although a private user is given an unlimited right to use the land this constraint is very important because:

- the user cannot sell the right to use the land in the case of withdrawal from development in
- the case that the investor does not need the whole plot for the development he cannot sell the undeveloped part of the plot to another investor;
- The investor has no idea what would be the compensation for the usage of the plot in the future. This depends on the decision of the local government authority.

FIC Recommends:

The right to use land, handling the right and obligations are not well defined. In the current Law on Urban Building Land, the price for the use of land is not explicitly referred to as the price for acquiring the right to use the land. This needs to be specifically clarified.

The procedure to acquire the right to use the land appears like a purchase but is not referred to as such. This needs to be amended so that the purchase is clearly stated as such.

Further, after the purchase of the right there is still the obligation to pay the compensation for the use. One might conclude that the right to use the land is not paid for in total at the moment of acquirement. There must be a method by which investors can determine in advance the compensation costs for the use of land.

Land tax is very high which is a factor discouraging new investments. There needs to be a reasonable tax placed on newly developed land.

Under present solutions, an investor is obliged to pay for the development of infrastructure and then transfer the utility works to municipal public utility companies who are the owners of the whole system.

The award of planning permission in accordance with the plan should include the connection to the infrastructure system. Because of insufficient coordination between different public utility companies this is rarely the case. It is recommended that

- This issue is dealt with so that once the investor has obtained his permission; he does not then have to negotiate and pay again to have the connection to the necessary utility companies.
- a reduction in these services costs is effected to avoid deterring the initial developers.

The present solutions where public utility companies acquire free assets from investors for their development are unsustainable. Public Utility companies ought to be required to pay for these assets.

8.1.1.2. Construction

Despite the needs of a post war country in transition, planning and property development are still rooted in the former system of a limited market economy (and predominately public interest) and not on the effective demand, prices, transaction costs, or market efficiency.

Due to increased investor interest there have been a number of legislative and administrative changes showing the following general tendencies in the field of planning and development:

Law on local self-government is the step towards decentralization: responsibilities of local governments have increased. Local communities are given responsibilities to make policies concerning the operation and allocation of the property. Local governments arrange urban land in correspondence with resources. Efficiency in issuing planning and building permits ("one-stop-shop"). The new Law on planning is expected to propose more efficient solutions.

Changes in the legal environment, privatization, liberalization and general deregulation are the preconditions for real estate markets and foreign investments. The present constitution still discriminates against private ownership in some areas. Large -scale and small-scale privatization is slow and the issue of property restitution has not yet been dealt with prolonging unclear conditions for the real estate market. The restitution process could create a strong impetus for the development of real estate market and assure basic property rights for all owners, regardless of whether it is private, individual, a legal entity or the state.

8.1.2. Planning and building permissions

The Government of Serbia still has not established an integrated system of national, regional and local development activities in two years. The former legal structure is still in place although the circumstances have changed dramatically. In that framework the whole task of preparing development conditions are left to local communities that lack skills and resources.

A draft Law on Planning, Building and Urban Land was completed in spring 2002 but is still not in place. Although this law attempts to improve planning and development it does not change the overall concept of development planning and policy according to the principles of the European Regional and Spatial Planning Charter and the EU structural policy with integrated socio-economic planning and physical planning.

All forms of development require a planning permission before work can begin.
Investors need be able to get clear conditions for any future development. Local government is increasingly interested in attracting new businesses to their areas. The existing local plan is the condition for issuing planning (development) permission for chosen location. All planning permission must comply with the provisions of the local government plan.

The uniform approach to planning and the complicated procedure prevents prompt reaction on the investors' requests. The planning procedures are not flexible to allow some degree of discretion. Limitations not necessarily applying only to foreign investors but to all private investors are local plans

and land preparation for building, absence of coordination in provision of services and infrastructure, urban land management etc.

FIC Recommends:

The introduction of comprehensive national spatial development strategy and of consistent policies in many fields such as housing, transportation, environment will be welcome. Currently disputes over new planning legislation create contextual and institutional uncertainty. There is no national or regional planning concept that would create a framework for the preparation of local plans. A national Development Strategy is required.

Under the present Law planning is perceived as an activity of the public sector in the field of urban development. Private players and their interests and preferences are still not recognized as major development factors so it is often only residual. Planning is still slow and ineffective, restrictive rather than incentive. Amended legislation should be introduced to correct this.

Technical planning has not been adapted to market conditions. Urban development is still regulated in detail, especially in relation to disposition and design of buildings. Development control and issuing permits are not permissive or flexible; they are not focused on key development areas but with same level of constraints on the whole city territory. Recommend that a new approach be taken regarding building design and such permits.

The right for foreigners to buy real estate (offices and apartments) is regulated by special regulations connected with property rights.

There is a principle of reciprocity. The investor has to obtain an opinion from the Federal Ministry of Justice that determines if there is reciprocity between the investor's country of origin and Yugoslavia that makes the procedure unnecessarily complicated. At the point of having the rights registered it ought to be known whether reciprocity exists between the two countries. This cuts out the need to have approval on each occasion.

Although local governments have recently organized the preparation of new land use plans recently (general plans and detailed regulation plans that are both binding documents) these are still lacking especially for areas with a high development pressure. The land use plans should be introduced for the areas with high development potential.

There are still great number of rules and regulations that are arbitrarily applied. Some areas of planning procedures are already under-regulated (maintenance of buildings, environmental impact). On the other hand others are manifestly over-regulated (including land development procedures, disposition and design of the building). The plans are not flexible and if there are changes on the demand side influenced by market conditions planning could not react efficiently. There are many negative measures (restrictions complicated and time consuming procedures) rather than positive measures (incentive planning, simple permit procedures, tax rebates.) A uniform application of the regulations should be applied and disciplinary measures introduced for infringing officers.

For foreign investors there is a bulk of addresses from federal ministries to republic ministries, different city and local institutions all dealing with the same matter of use and permits with respect to construction and building. We strongly recommend that a single agency be established which will be responsible for the administration and issuing of all the necessary permits to allow foreign investors acquire.

8.2. Pharmaceuticals

In the effort to secure their presence in the Serbian market, pharmaceutical companies developing and marketing innovative drugs are facing constantly increasing competition from generics and have in general been unsuccessful in their pricing discussions with the Yugoslav health fund. With the cost and complexity of research and development in pharmaceutical companies ever rising and the patent expiration issue, generic companies are increasingly dominating this market.

Health Fund assembly, under the authority of the Ministry of Health, had not assessed any of the new applications for the reimbursement list in the previous eighteen months. As a result, a large number of

medications used in hospitals are not reimbursed, and patients are buying these pharmaceuticals from pharmacies "over the counter", without prescription. Health funds of the neighboring countries, such as Bulgaria, Romania, Croatia etc. provide partial or full subsidy for the newer therapeutics.

Persistent black market generates sales outside the country and defies the presence of the representative office in former Yugoslavia. This type of illegal trade also raises the question of the quality of pharmaceuticals used by the consumers as well as the lack of comparative clinical monitoring usual for initiation of therapy with recently developed pharmaceuticals.

Tax imposed on pharmaceuticals in former Yugoslavia is 20% on all products not listed on the Reimbursement list. Tax and all the other costs associated with import and handling of pharmaceuticals can increase the price for additional 72%. 20% tax is also imposed on pharmaceuticals that are given free of charge from short-dated or other gifted consignment stock, including goods for clinical trials, which again, is an additional burden to the representative offices.

With the cessation of operation of the National Ministry of Health, and the different responsibility of the newly formed Drug Agency, renewal of registration for new medicines and import licenses for foreign-made medicines can not be obtained at the moment.

We suggest that different tax categories should be instituted and certain therapeutic exempt from taxation with the decrease in some of the import and/or quality control costs.

Reimbursement list should be regularly updated and if some of the newer therapeutic options can not be fully funded, introduce reference pricing.

Timely registration and import licensing would enable us to compete in a fair environment with the domestic producers.

8.3. Telecommunications

Current status

Telecommunication market is well known as being one of key drivers for economical reforms and growth. Despite this fact, the impression is that still there is neither a clear strategy nor transparency concerning the development of the telecommunication sector. One of the most obvious indicators in this regard is the lack of relevant legislation (i.e. new telecommunication law) that has been expected for quite some time.

The above - stated is particularly important having in mind that such a situation definitely causes major current competitive disadvantages for the country, consequences of which are usually primarily visible in impeding progress in evolution to EU ascendancy and WTO compliance as well as in overall disincentive to additional foreign investments.

FIC Recommends:

- Liberalization and regulation of the fixed line market
- Liberalization and regulation of the mobile line market
- Liberalization and regulation of internet market
- Consequent introduction of new, modern (in accordance with EU standards) telecommunication law

8.4. Press and Media

There are some differences of the Serbian media market in comparison to the markets of the neighboring countries and the rest of Europe in several basic aspects.

The economic impact of sales tax on the media products clearly is in conflict with the goal to create a liberal press climate. The press media has an important role in democracy oriented countries through strengthening freedom of speech, supporting opinion differences and taking over social responsibilities.

The sales tax for press products (newspapers and magazines) in Serbia amounts to 20%, the same percentage as it is for the most of the other products. In other European countries, the tax for media (press) products is lower or there is none.

Country	*Sales tax*	*Magazines*	*Newspapers*
	%	%	%
West Europe			
Austria	20	10	10
Belgium	21	6	0
Dennmark	25	25	0
Finland *	22	0/22*	0/22*
France	19,6	2,1	2,1
Germany	16	7	7
Greece	18	4	4
Ireland	21	12,5	12,5
Italy	20	4	4
Luxemburg	15	3	3
The Netherlands	19	6	6
Norway	24	0	0
Portugal	19	5	5
Spain	16	4	4
Sweden	25	6	6
Switzerland	7,6	2,4	2,4
UK	17, 5	0	0
Central and Eastern Europe			
Croatia	22	22	22
Romania	19	19	19
Montenegro	20	0	0
Republika Srpska	20	0	0
Macedonia	19	5	5

* In subscription cases VAT amounts to 0% (both for magazines and newspapers)

The decrease of the tax would give the possibility for publishing houses to achieve several goals:

- Strengthening and supporting of media freedom, independence and impartiality of press products as well as stratified press climate
- Creating a friendly-related investment climate for publishing houses, that would enable impact on investments (staffing, human resources development, technical improvements, deepening of the product palette)

FIC recommends:

We highly recommend decreasing the sales taxes or freeing the media from it altogether, to give a positive impetus to media-publishing houses.

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