FOREIGN INVESTORS COUNCIL

Proposal for Improvement
of the Investment Climate in Serbia

2005

Regaining Momentum

Preparation of the 3rd edition of the White Book is an important milestone. The fact that so many of our members remain willing to again devote their time to this project indicates their continuing commitment to Serbia. There is tacit acknowledgement of some success achieved by previous years' editions.

In preparing the White Book, we, the foreign investor community, are going out on a limb by presenting our views about the business environment in Serbia. As such, the process itself is analogous to the preparation of annual financial statements. The White Book presents our assessment of the year 2004 (the income statement), the position at 31 December 2004 (the balance sheet), and our expectations for 2005 (the budget). The audience for the White Book is the Government and the civil service, the Serbian public and potential foreign investors. Similar to financial statements, the FIC would commit a disservice to all these groups if the White Book is not objective.

The following pages present some good news, most notably the adoption of many laws, and we acknowledge the efforts made in tightening government spending. However, the adoption of laws without implementation and enforcement achieves little. Furthermore, the momentum which Serbia's transition process had gathered in earlier years has now dissipated. This momentum must be resuscitated in 2005.

As business people, the FIC does not have unrealistic expectations. A major opportunity to regain momentum will be for the Government to acknowledge the results of the EU's feasibility study and use this to guide most of its long-term policies in future years. Additionally, however, more tangible short-term signs of progress are a must in 2005.

In 2005, the FIC is looking to see the successful implementation of the VAT law, the bankruptcy law, the bilateral free trade agreements and clear progress in the real estate and construction sector. We are distressed at the low levels of foreign direct investment in 2004, with the only major successes being in the banking sector. The FIC would like to work with the authorities in rectifying this situation.

The greatest economic challenge which Serbia faces in 2005 is restructuring the country's infrastructure: transport, telecommunications, energy. When speaking to potential foreign investors, questions about the infrastructure are always asked. Here again, we must see some positive steps.

Politics cannot be allowed to obstruct the transition process and impede the regaining of momentum. Events in Kosovo, as well as Serbia itself, must not be an excuse for inaction.

As always, the FIC sees itself as a partner to the government and the civil service. Our members want to make Serbia a success and will contribute their time and efforts to achieve this goal. We hope that 2005 will see more continuous and constructive dialogue between the government and ourselves.

Finally, I would like to thank the many contributors to the 2005 White Book, and most particularly Maja, who dealt with the organisational aspects. My hope is that your time has been spent wisely.

Belgrade, March 2005

Mike Ahern
President and Spokesman
Foreign Investors Council

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FIC Perspectives, March 2005

'Breaking Out of the Serbian Bubble'

FIC Perspectives, March 2005, encapsulate the top-of-mind economic issues we believe face Serbia. Currently, extremely close attention to domestic matters is impeding the ability to see beyond day-to-day issues in the country. Domestic and international perspectives need to be combined to break out of the Serbian bubble, thereby leading to increased new foreign direct investment (FDI) and sustainable improvement in the Serbian economy.

The following **perspectives** of the **Foreign Investors Council (FIC)** have been selected on the basis of the unified voice of the FIC members and, we believe, largely correspond to the reform targets of the **OECD-Investment Compact Monitoring Instruments** and to those of other international organizations such as the **EC**, **IMF** and **World Ban**k.

1. Fundamentals:

- Infrastructure reform: notably in telecommunications (lines availability), transport (road conditions), office/industrial space
- Free market: need for an open and transparent market e.g. in urban - construction land

2. Implementation:

- Application of the laws: new laws should be applied e.g. bilateral free trade agreements (FTAs), bankruptcy law, electronic signature Transparency and dialogue primarily related to legal reform: should be strengthened to reduce uncertainty, to enhance predictability in the business environment and to facilitate effective implementation
- Dealing with authorities and courts: management time is lost, laws are not applied

3. EU :

- Feasibility study: if positive when finalized in March 2005, it will initiate a clear, strict and predictable economic reform agenda i.e. the "acquis communautaire", a measure for progress made, and help Serbia achieve the necessary standards for its economic integration into EU and world markets

4. Foreign Direct Investment:

- Increased level of new FDI: needed is a clear strategy (sectors), (focused) targeting of investors, one-stop-shop.
- Regaining of Momentum: while investment commitments related to previous foreign direct investments made by some investors allow for some minimum FDI level each year, new Greenfield FDI must be actively sought and proper "climate" should be promoted to secure significant new FDI by existing investors (who represent in average 50% new FDI in OECD countries).

For more detailed information, including the obstacles for business and investment together with FIC proposals for improvements, please refer to the text in the FIC White Book 2005.

Chapter 1

Foreign Investors Council - Overview

The Foreign Investors Council (FIC) was founded by 14 major foreign investors in Serbia with the support of OECD - Investment Compact for South East Europe at the official foundation meeting (Constituent Assembly) on 15 July 2002 in Belgrade, 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."

The main purposes of the Foreign Investors Council are to improve the investment and the business development climate in Serbia and Montenegro by making concrete reform proposals, to stimulate foreign direct investment, to promote communication between the Foreign Investors and the authorities in Serbia and Montenegro - in order to assist and support the international business community and help in overcoming difficulties which might be encountered in a course of investment.

The aims of the FIC are:

- Improvement of the investment and business climate in Serbia and Montenegro, by making concrete reform proposals
- Stimulation of foreign direct investments
- Promoting communication between the FIC and the Serbian Authorities
- Assistance in overcoming difficulties which may exist in relations with foreign investors
- Link with other foreign investor organizations across the SEE 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

Besides those already mentioned, one of the purposes of the FIC is also to link with other foreign investor's organizations across the SEE Region, to benefit from best-practices sharing and to study concrete means to facilitate regional operations, in partnership with all relevant authorities, international organizations and institutions.

Almost 100 companies - current members of the Foreign Investors Council - have a long lasting presence in SEE 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 experiences, common interests and economic strengths to build a better enabling framework for future business in Serbia, as well as in South East Europe.

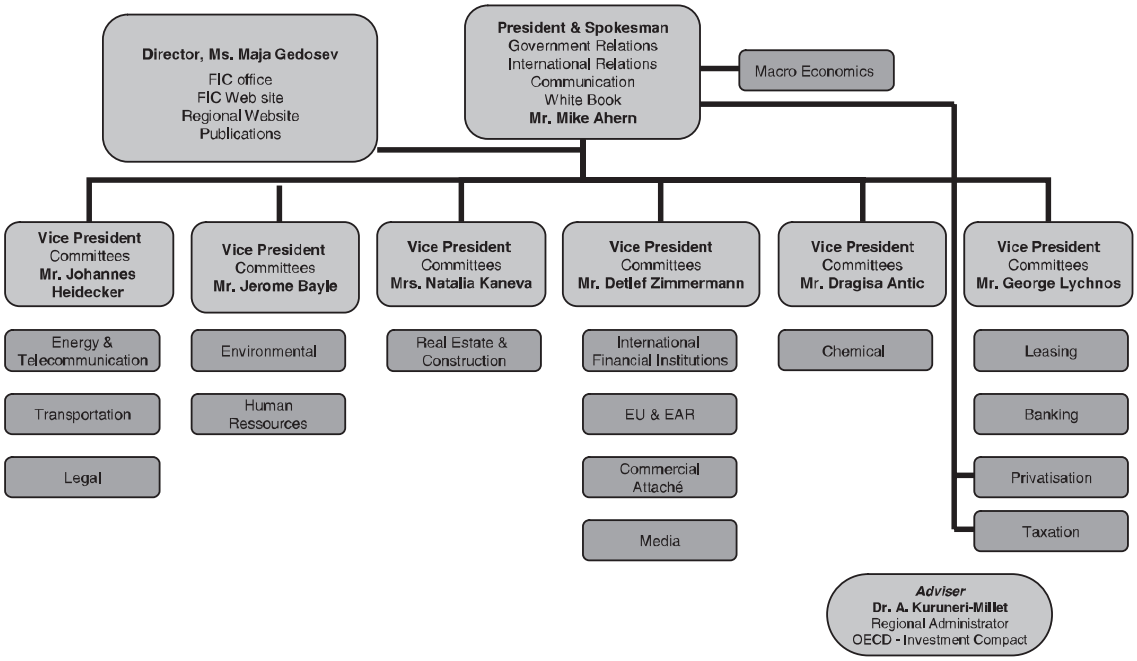
In its current development stage, the FIC is a powerful and constructive tool of reference. It represents most of the FDI stock in SCG, over 15 different nationalities, a vast range of economic sectors, a large part of employment and high economic interaction with domestic SME's.

The FIC has 12 specialized working committees which meet on a regular basis and have counterparts within the government and administrations. Committees are grouped into sector based: banking, chemical, construction, consumer goods, energy & telecommunication and media; and cross functional committees: environmental, human resources, taxation, leasing, legal and insurance.

The FIC operates in partnership with OECD - Investment Compact for SEE and closely cooperates with major international organizations present in Serbia and Montenegro, such as IMF, The World Bank, The Delegation of the European Commission, EBRD, EAR, IFC, and the European Union.

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 President/Spokesman and Director.

Foreign Investors Council Organisation



The White Book 2005 of the Foreign Investors Council summarizes the main obstacles to investment and business development in the country and formulates concrete proposals to overcome these impediments. It is designed and presented by the FIC as an instrument for constructive dialogue and partnership between investors and government authorities that can help to improve the business and investment environment and lead to increased private investment.

This book is also a reference for the monitoring process of reforms set by the OECD - Investment Compact for SEE within the framework of the Stability Pact for South East Europe. The White Book is therefore also a natural part of the monitoring process of reforms set by the OECD - Investment Compact for SEE.

By publishing the White Book 2005, the FIC aims to respond to the Serbian authorities on some chosen subjects which are linked to several sectors of the economy. This publication can not cover all aspects of the Serbian economy and therefore 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.

The White Book 2005 can be downloaded from *www.fic.org.yu*

Contacts for the Foreign Investors Council are:

Mr. Mike Ahern, President/Spokesman
mike.ahern@yu.pwc.com

Ms. Maja Gedosev, Director
Maja.gedosev@fic.org.yu

Foreign Investors Council Office
Hyatt Regency Hotel
5, Milentija Popovica Street
11 070 Belgrade
Serbia and Montenegro

Tel: +381 11 301 1155
Fax: +381 11 301 1242

E-mail: office@fic.org.yu
Web-site: www.fic.org.yu

PRESIDENTS OF FIC COMMITTEES

Banking	Dragisa Lekic, Volksbank	Dragisa.LEKIC@volksbank.co.yu
Chemical	Vladislav Sywala, Teh. Messer	vladislav.sywala@tehogas.co.yu
Real Estate &Constr.	Natalia Kaneva, Colliers	natalia.kaneva@colliers.com
Energy & Telecomm.	Milena Gajovic Shrestha	milena@bedminsterinvestment.com
Transportation	Nebojsa Mandic, DHL	nebojsa.mandic@beg-co.yu.dhl.com
Macro Environment	Mike Ahern, PWC	mike.ahern@yu.pwc.com
Human resources	Danijela Jankovic, Tetra Pak	danijela.jankovic@tetrapak.com
Taxation	Mike Ahern, PWC	mike.ahern@yu.pwc.com
Leasing	Ognjen Medic, Raiffeissen Bank	ognjen.medic@rba-belgrade.raiffeisen.at
Legal	Patricia Ganon	patricia.ganon@karanovic-nikolic.co.yu
Privatization	Mike Ahern, PWC	mike.ahern@yu.pwc.com
Media	Jack Barbanel, MIG	JBINVEST@aol.com

Chapter 2

Economic Overview

After relatively slow growth of 3.0% in 2003, most of the available data suggests that economic activity in Serbia picked up noticeably in 2004. Industrial production is recovering, having grown 12.0% y-o-y in November and 7.0% in the first eleven months of 2004. This compares favourably to the same period last year when industrial production had fallen 3.5%. Agricultural production is also up sharply with better weather providing a welcome boost. The service sector has also been very important in generating growth recently.

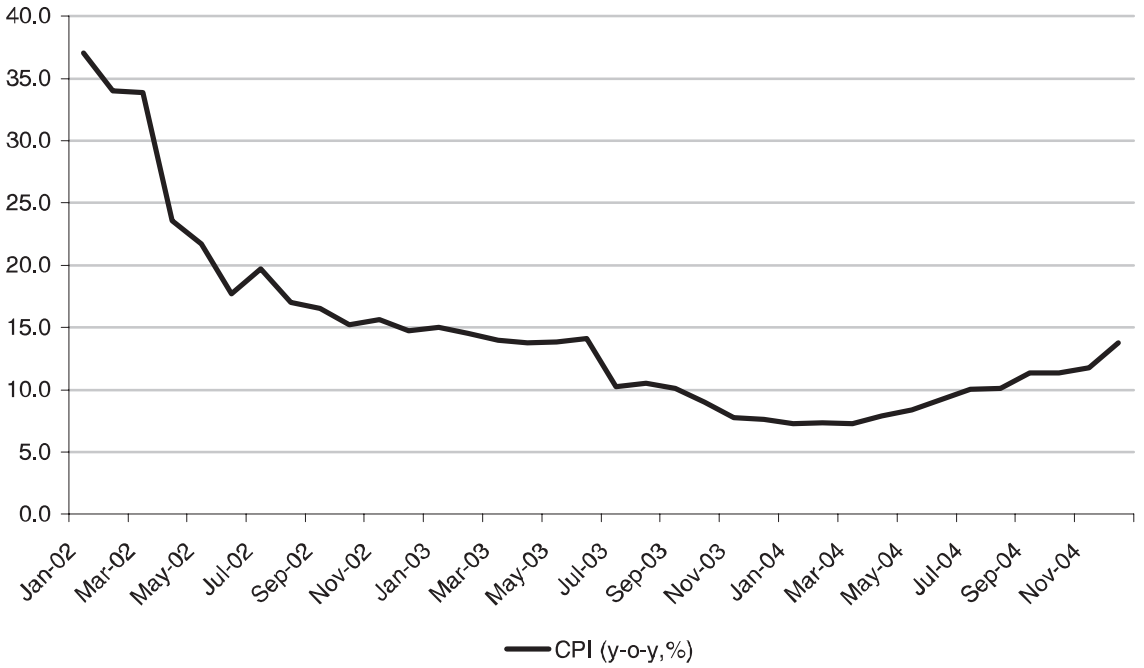
Private consumption also appears to be picking up, with real net wages up 12.8% in the year to October 2004. At the same time, credit activity to both households and enterprises has increased. Overall, credit activity has increased 9.6% in the first eleven months of the year. This does, however, represent a slowing of credit activity. Unemployment remains very high at 31.7% in October. Nonetheless, the extensive grey economy in Serbia, and the significant private remittances the country enjoys each year, provide ample evidence that an increase in private consumption is occurring.

While data on investment activity is more difficult to come by, imports of capital goods do point to an increase in investments. Overall, we expect the Serbian economy grew at least 6.0% in 2004. The weaker external environment, the continuation of tight monetary and fiscal policies, and a less robust contribution from the agricultural sector to growth, lead us to expect growth of up to 4.0% in 2005.

Despite an increase in the inflation rate in 2004, the previous four years have marked a significant downward trend in inflation. Given the logical, significant increase in a number of government charges and utility services' prices over the past 4 years to ensure economic provision of services, this is a major achievement. In 2004 inflation has increased 9.7% on average and ended the year at 13.8%. While higher oil prices have played a role in pushing inflation up, large wage increases, which have again exceeded productivity gains, and a depreciating nominal exchange rate have also contributed to higher inflation in 2004. Base metal price increases have also played a part. The structure of the Serbian economy, with a number of heavy industries reliant on base metals imports, has thus influenced inflationary developments this year. Oil prices will moderate in 2005 compared to last year and this will be a welcome help to the authorities in their quest to lower inflation. Yet, as 2005 has seen the long-awaited introduction of a Value-Added Tax (VAT), which will generate a one-off inflationary impact and electricity prices will again be increased, inflation will trend higher this year.

For 2005 we expect to see annual average inflation of 12.4%, largely due to the one-off inflationary impact of the VAT. Nevertheless, during 2006 we expect inflation to return to single digits and to eventually converge towards the European Monetary Union (EMU) average.

Consumer Prices, % change year on year

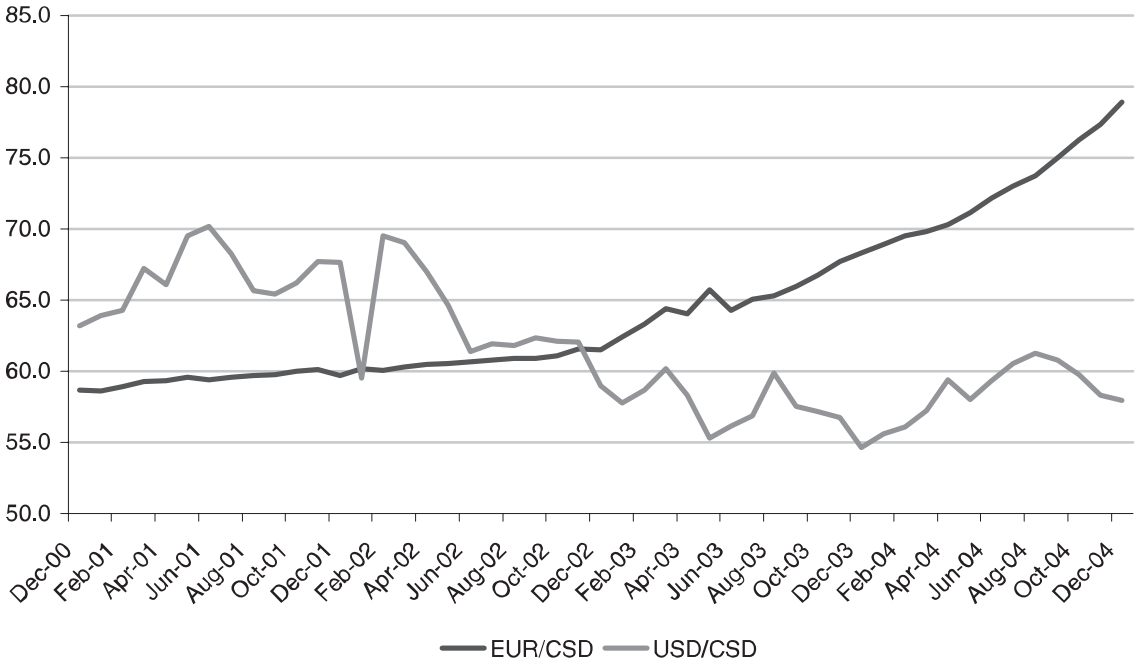


Source: NBS CA IB

The National Bank of Serbia tightened monetary policy in August 2004 by increasing reserve requirements by three percentage points to 21%. As there is uncertainty surrounding the external position (see below) and inflation has again trended up, we expect the NBS to maintain a tightening bias for monetary policy over the next 12-18 months. Thus, further increases in the reserve requirement would not be a surprise. As part of this tight monetary policy we expect NBS interest rates, which have been noticeably lower than Ministry of Finance T-bills rates, to trend upwards. By extension, we do not see the current level of Ministry of Finance T-bill rates (20%) coming down significantly over this period. Local market liquidity conditions in Serbia will continue to almost exclusively be a function of local market developments, given the extensive capital controls in place in Serbia.

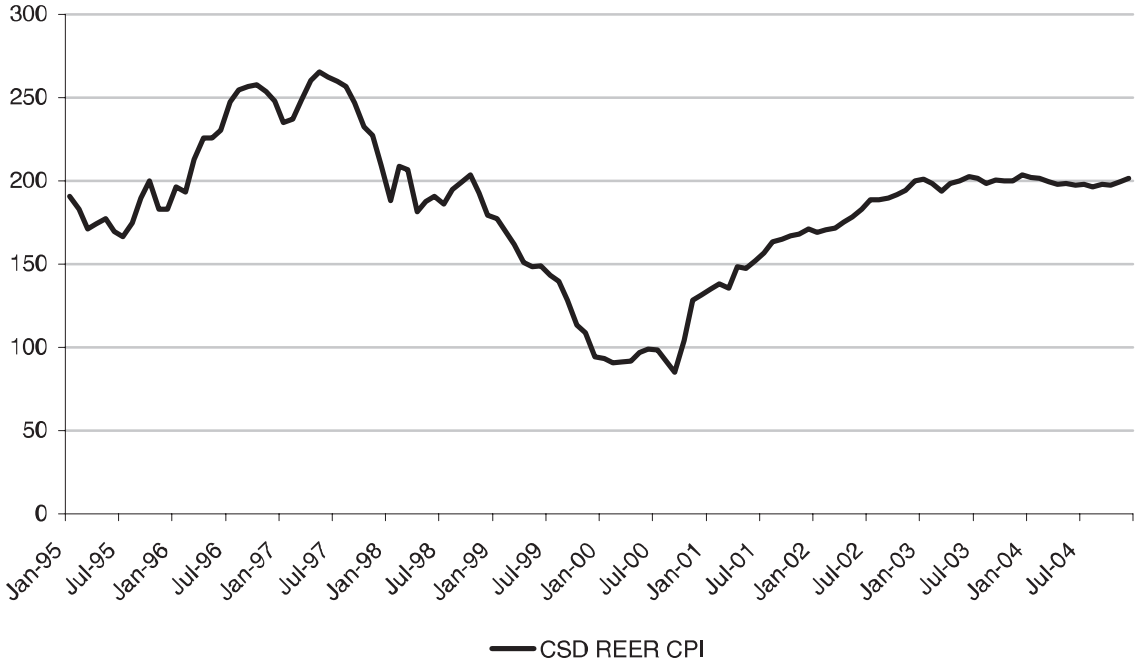
The main goal of monetary policy remains the achievement of low inflation. However, the National Bank of Serbia is also pursuing a policy of maintaining a stable real exchange rate after a period of appreciation from very low levels, as the graph over demonstrates. Therefore, the NBS is maintaining one eye on inflation and another on external price competitiveness. As such, we expect the EUR/CSD to continue depreciating in nominal terms in the medium-term. However, as inflation converges towards EMU levels, this rate of depreciation will slow.

Nominal Exchange Rate EUR/CSD, USD/CSD



Source: NBS

Real Exchange Rate (CPI based, Dec 2000=100)



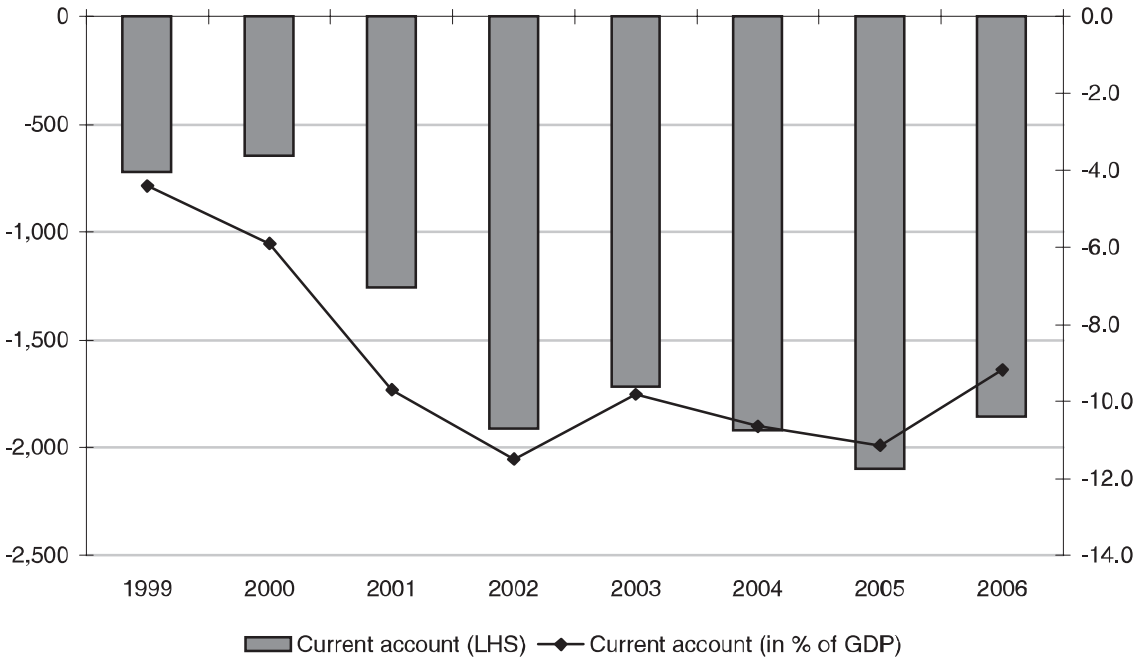
Source: NBS, CA IB Estimates, note increase in index indicates an appreciation

Given Serbia's fragile external position, there remains a risk that the EUR/CSD will come under further depreciation pressure in the medium term. As the IMF notes, there is also uncertainty surrounding the errors and omissions item of the balance of payments, which rather than reflecting unrecorded capital inflows, may reflect the reduction of foreign assets held outside the banking sector by residents to finance consumption. Although Serbia negotiated a write-off of US$1.8bn in London Club debt in June 2004, which should see gross foreign debt fall below 65% of GDP at the end of 2004, the country remains exposed to external sector risk. In addition, the growth outlook for both the EU and the US in 2005 is weaker than in 2004, which inherently represents a risk to export growth, generating a further challenge for policymakers.

For the past two years, wage increases have outstripped productivity growth, which is detrimental to export growth. Export growth has remained poor, reflecting the need for further restructuring in the enterprise sector. The government's plan to embark on the restructuring of the largest socially/government owned companies recognises this fact, however, the results of the successful implementation of this policy are unlikely to be reflected in greater exports immediately. In addition, privatisation and restructuring in the banking sector which is continuing will lead to a more efficient banking sector, which will be a major boost to economic activity, including exports.

Import growth accelerated in 2004 in real and nominal terms. To an extent this is a logical reflection of the recovery in industrial production. After all, numerous inputs into the production process have to be sourced from abroad. Serbia, in that regard, is no different from other countries in the region. In addition, the import of capital goods reflects the commencement of restructuring initiatives and another investment cycle. This should also not surprise, given more stable foreign direct investment flows. Nonetheless, increases in wages and greater credit activity have also contributed to increased imports due to household demand. In our opinion however, while investment and production activity will continue to generate demand for imports, our expectation of continued tight monetary and fiscal policies should see private and government sector consumption moderate, even though private consumption is still evidently being fuelled by stores of wealth outside of the banking system (and therefore not entirely captured by official statistics). This should see the current account deficit convergence towards 5% of GDP in the medium-term, from current levels of over 10% of GDP. For 2005, the less constructive external growth outlook leads us to forecast a current account deficit of 11.1% of GDP.

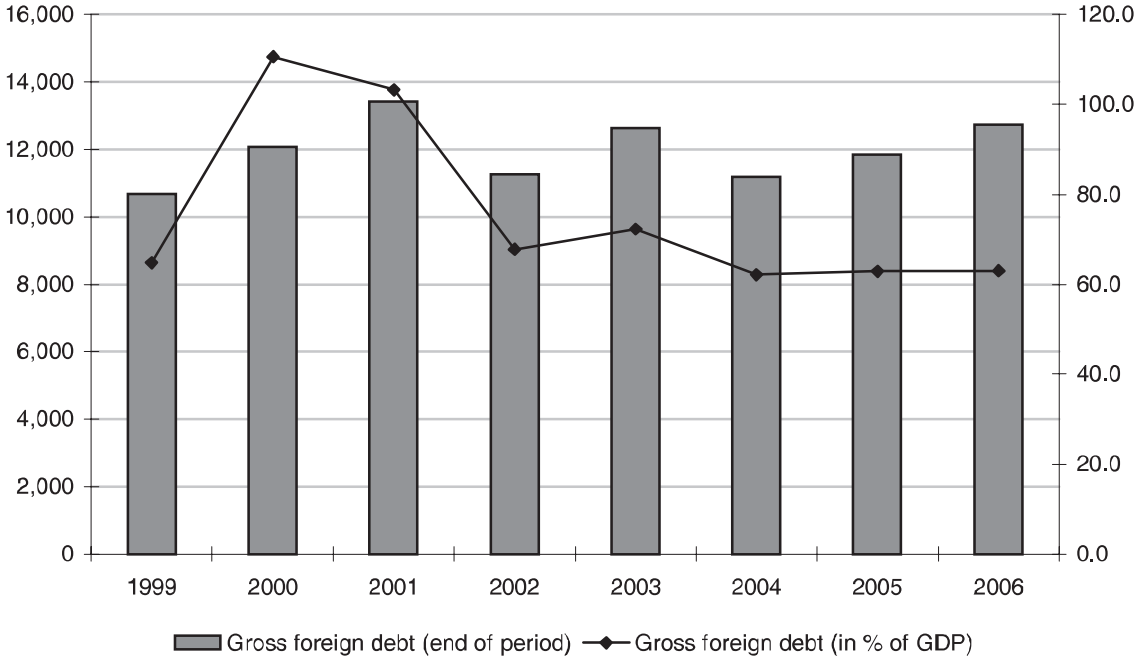
Serbia Current Account Deficit (including grants)



Source: NBS, CA IB Estimates

With the less attractive state-owned assets now up for sale, the pace of FDI inflows is likely to slow in the short-term. Although concessional lending and other grants will continue to be granted to Serbia, such a high current account does mean that foreign debt will continue to grow. We expect gross foreign debt to remain above 60% of GDP until 2010.

Gross Foreign Indebtedness



Source: NBS, CA IB Estimates

Import cover at the moment exceeds 4 months and in 2004 and 2005 with external grants and concessional loans expected to exceed US$1bn per annum combined with FDI and debt-creating inflows the level of FX reserves, at US$4.0bn at the end of November, is adequate.

In May 2005, Serbia will have completed the three-year extended agreement with the IMF. With the London Club debt rescheduling completed successfully, Serbia gained a B+ credit rating with a stable outlook at the beginning of November 2004 from S&P. Once the Extended Agreement with the IMF is successfully completed in May of this year this credit rating will allow the country to access international capital markets, providing a much needed source of more affordable external financing.

While this will be a welcome development, the need for consistent macroeconomic policy remains important. Over the first half of this decade, Serbia has negotiated debt write-offs which have reduced the gross external debt to GDP ratio to an estimated 62% at the end of last year. No such one-off benefits can be expected any more. The current account deficit remains large and the restructuring efforts required to sustainably increase export growth in the medium to long-term will require time and persistence. While tight macroeconomic policies should see consumption and therefore import growth moderate an adjustment in the current account deficit will not be instant. At the moment, the ability of the Serbian economy to generate foreign exchange income is not as great as it should one day be, hence the external grants and concessional loans which are still key to maintaining external liquidity. With debt service projected to rise in the remainder of the decade as both a percentage of GDP and exports, the risks the external sector represents to Serbia's macroeconomic stability should not be dismissed.

Fiscal policy has been tightened in Serbia during 2004. The original budget aimed to reduce deficit mainly through revenue measures. The summer budget rebalance sought to redress this approach by freezing public sector salaries and reducing subsidies. The government, in 2005, is aiming for a consolidated government budget deficit of 1.7% of GDP. We would consider this target to be exposed to upside risk, given that it is never easy to generate expenditure cuts on issues such as subsidies quickly. In the medium term, the issue of the transition cost of pension reform will represent further pressure on fiscal policy. At the moment, the deficit of the pension fund amounts to close to 6.0% of GDP. Nonetheless, the budget deficit is low and does add to the credibility of economic policy in Serbia. Maintaining prudent fiscal policy will be an important element of maintaining macroeconomic stability given increasing public debt service costs in the second half of this decade. To date, the Serbian authorities have been able, in co-operation with the IMF, to implement a broadly restrictive fiscal policy. Given the external constraints Serbia faces, we believe fiscal policy will remain broadly prudent in the medium-term.

The 2005 budget can expect a one-off boost from the introduction of a Value-added Tax, whose base rate is 18% while the concessional rate is 8%. Generally, introductions of a VAT see revenues exceed forecasts and there is no reason to expect that Serbia will be any different. In this event, the government would do well not to increase spending or slow its reform initiatives.

Indeed, the authorities are setting into place an ambitious three-year macro-fiscal scenario, which forms the basis of fiscal policy from 2005 to 2007. The broad aim of policy is to ensure growth of 5% per annum, to increase the share of investment from the current 16% of GDP to 20% by 2007, to increase real export growth to 15% per annum and to maintain low inflation.

The increase in investment activity would be taken up mainly by the private sector, with FDI inflows a key component, but also by an increase in government funded infrastructure investment. That will require further reductions in current spending, which will be politically challenging. For a start, the Serbian government spends 10% of GDP on public sector wages, while 13% of GDP goes on pension spending. Cuts to defence and police budgets are likely to prove less challenging than the health, education and social welfare portfolios. Yet, the need to cut jobs in an effort to attract strategic partners to a number of publicly and socially owned companies and the need to reduce subsidies to the industrial sector will present the government with a challenging policy environment in 2005.

There are evidently a number of risks to the Serbian economy, both in the domestic and international spheres. Delays in the implementation of the reform programme would slow the increase in the medium-term sustainable growth rate, potentially raising questions over debt sustainability in an environment of (admittedly slowly) rising global interest rates. While we expect oil prices to moderate in 2005, domestic wages developments could provide an added challenge to the authorities' inflation goals, while expected slower growth in the US and EU this year presents a risk to the export growth targets.

While noting the risks the Serbian economy is exposed to, we maintain a constructive view on developments in the medium term. Further progress on enterprise sector reforms, improving the efficiency of product and labour markets and the general business environment will be necessary to boost inward investment and export potential. Combined with tight fiscal and monetary policies, which we expect to remain in place for at least the next few years, this will go a long way to ensuring macroeconomic stability. In the meantime, the achievement of a sovereign credit rating provides Serbia with access to international capital markets ensuring more cost effective refinancing of existing loans and a more stable source of finance for future obligations.

Chapter 3

Delegation of the European Commission to Serbia and Montenegro (Contribution)

"Building on the European Partnership"

The Feira European Council of 2000 and subsequent meetings held in Zagreb (November 2000) and in Thessaloniki (June 2003) cleared the European prospects for the State Union Serbia and Montenegro[1] as a potential candidate for EU membership. The relationship between the European Union (EU) and Serbia and Montenegro (SCG) has since been based on the perspectives of further EU enlargement and the interrelated ultimate goal of Serbia and Montenegro to become an EU member.

Stabilisation and Association process (SAp) and its instruments

In line with the established political framework, bilateral economic and political relations between the EU and SCG have been significantly intensified since October 2000. In particular, SCG started the **Stabilisation and Association process** in a manner corresponding to other Western Balkan countries and has benefited greatly from the various SAp-related instruments.

- Firstly, in order to help the country's economic recovery, in September 2000, the EU granted generous **autonomous trade concessions** extending them to practically all products in November 2000 after the democratic changes in Belgrade. These preferences allow unlimited duty free access to the EU for almost all exports from Serbia and Montenegro.

- Secondly, the EU **financial support**, which also existed prior to 2000, has been substantially increased in the form of regional and national Community Assistance for Reconstruction, Development and Stabilisation (CARDS) projects and Macro-Financial Assistance.[2]

- Thirdly, the EU has been offering its **bilateral technical and political support** in multilateral SCG matters such is the accession to the World Trade Organisation, the Stability Pact initiative, the negotiation and conclusion of free trade agreements with the countries in the region, etc.

- EU vision

In the period from 2000 to 2004, a constant dialogue between the European Commission services and the relevant SCG and republican ministries has been conducted and **joint recommendations** were issued, giving reforms a strong European frame. This dialogue has also put forward the so-called twin track approach which was formally endorsed by the highest SCG officials on 5 October 2004 and by the General Affairs and External Relations Council (GAERC) on 11 October 2004. The **twin track approach** came as a response to the complex constitutional situation in SCG and stalemate reached on the side of implementation of the Constitutional Charter. On the basis of that the newly endorsed

[1] *At the time, the Federal Republic of Yugoslavia (FRY).*
[2] *Community financial support amounts to EUR 1.8 billion for the period 1991-2003, with more than EUR 1.6 billion being granted since the fall of the Milosevic regime. Macro-Financial Assistance amounted to EUR 475 million in the period 2002-2004 plus EUR 70 million envisaged for the year 2005.*

twin track approach, the Commission has re-launched the work on the **Feasibility Report**. The Feasibility Report should assess the administrative and institutional capacity of SCG to negotiate, conclude and implement the obligations arising from the future Stabilisation and Association Agreement (SAA) with the EU.

Necessary reform agenda

In order to help the country consolidate around the most important issues and priorities, the Council of the EU has issued on 14 June 2004 its decision on the principles, priorities and conditions contained in the **European Partnership**[3] with Serbia and Montenegro. The decision contains the set of short-term priorities, which are expected to be accomplished within one to two years, and medium-term priorities, which are expected to be accomplished within three to four years. All these priorities, however, need to be implemented in order for the country to progress on its way to the EU.

The **political priorities** address the following areas:

1. **Democracy and rule of law** through the full respect of the Constitutional Charter, army reform, completion of electoral law reform, strengthening of the public administration, strengthening and maintaining of administrative capacity of the institutions dealing with European integration at the state and republican level, enhancement of judicial reform, fight against corruption, etc.

2. **Human Rights and Protection of minorities** by fulfilling Council of Europe obligations, setting up an Ombudsman Office and strengthening its administrative capacity, paying attention to elimination of torture, ensuring freedoms of expression and association, securing property rights by adopting and implementing legislation on property restitution, taking care of refugees, displaced persons and minorities, etc.

3. **Regional and international cooperation/obligations** through insurance of full cooperation with the International Criminal Tribunal for the former Yugoslavia and full respect of the UNSCR 1244, continuous dialogue with Pristina on practical issues of common interest, securing and strengthening of stability and regional cooperation, complying with the stabilisation and association process requirements and Thessaloniki commitments in terms of regional cooperation, ratifying and fully enforcing all free trade agreements and all other international agreements concluded by the state, and similar.

Moreover, the **economic priorities** relate to the following:

1. **Establishment of a market economy and structural reforms** by ensuring sustainable macroeconomic stability, liberalisation of remaining prices and removal of administrative controls, speeding up of restructuring, privatisation and/or liquidation of large socially- and state-owned enterprises, development of a stable and functioning land/real estate market, development and implementation of a comprehensive strategy promoting employment and combating unemployment, developing reliable statistics, completing the privatisation process and financial (bank) restructuring, strengthening a business environment conducive to private sector development and employment, etc.

2. **Management of public finances** through continuous formalisation of grey economy and broadening of the tax base, implementation of public expenditure management system (treasury, public internal financial control) and comprehensive tax reforms, improvement of the budget process and financial management, establishment of effective procedures for the detection, treatment and follow-up of cases of suspected fraud and other irregularities affecting national and international funds, continuous reviewing of fiscal legislation and administrative procedures in order to ensure effective and non-discriminatory enforcement of the tax legislation, continuous strengthening of the administrative capacity of the tax administrations, and similar.

3. **Internal market and trade** via full implementation of all agreed elements of the Internal Market and Trade Action Plan, abolishment of all import levies, additional charges and the import licensing

[3] *Council Decision 2004/520/EC, Official Journal of the EU, L 227 of 26 June 2004, pp. 21-34.*

system for steel and iron products that were introduced in violation of the standstill clause enshrined in the EU's autonomous trade preferences, abolishment of export duties on ferrous and non-ferrous metals and rawhide, continuous modernisation of customs administrations, strengthening of the area of intellectual property rights, etc.

4. **Sector policies**, and in particular activities that need to be undertaken in the agricultural, transport, energy, industry and small and medium enterprises, telecommunications and environmental sectors.

Implementation of European Partnership priorities

It is important to note that the political and economic conditions of the SAp are in no way altered by the twin track approach. Therefore, it is of outmost importance for the country's progress towards the EU to follow and implement the joint policy recommendations[4] and the European Partnership priorities. Also related to that is the proper and full implementation of the **Actions Plans for the Implementation of the European Partnership** already prepared and adopted by all three administrations. Furthermore, it should not be forgotten that the final responsibility rests on the authorities of SCG to implement all the necessary reforms and integrate the European dimension in all the legislative acts they propose. Undoubtedly, this will also be their formal obligation, once the country signs the Stabilisation and Association Agreement with the EU.

The future SAA

Depending on the Feasibility Report's positive assessment of SCG's capacity to negotiate and implement the future SAA, the country will enter into a new phase in the process of European integration. With the SAA signed, what is now the European perspective will turn into a clear path towards EU membership. The **Stabilisation and Association Agreement** with Serbia and Montenegro would thus already reflect the new rights and obligations relating to that membership. In practical terms, an SAA would consist of common chapters on State Union matters, negotiated with State Union representatives, and substantive separate annexes negotiated with the republics on all matters within their competences as sketched above. These annexes would in particular cover trade and economic issues as well as sectoral policies that fall under the republican competencies. This model would enable the EU and its Member States to engage in a substantial contractual relationship with Serbia and Montenegro, properly enforceable with one or all of the responsible partner-governments. For foreign direct investors in particular, it would provide a clearer ground on which to base their assessment of business opportunities. For the state union and republican authorities it would provide a great incentive towards accelerated reform.

[4] Policy recommendations represent the joint result of the representatives of the European Commissions and the SCG authorities reached during the Consultative Task Force (CTF) and Enhanced Permanent Dialogue (EPD) meetings, the last of which took place in Belgrade on 27 and 28 January 2005.

Chapter 4

Legal and Regulatory Framework

Company Law

The long awaited Company Law of the Republic of Serbia was enacted on November 22, 2004 and came into force on November 30, 2004. This law regulates the incorporation of companies and entrepreneurs, corporate organization and governance, affiliation and changes to corporate status and legal forms of companies, liquidation of companies. By enacting this law, the provisions of the old Company Law are no longer applied, except those provisions dealing with socially owned companies and regulating corporate governance of companies that entered privatization procedure.

Particular laws are in effect in specialized areas such as insurance, banking and the stock exchange. In these areas, the general provisions of Company Law are applied only supplementary to other legislation dealing with that area.

According to the Law on Foreign Investments, foreign persons, both legal and natural, are generally given the same legal status with respect to establishing companies in Serbia.

There are four types of companies that may be established in Serbia, that already existed under the previous Company Law. These types include: partnership, limited partnership, Limited Liability Company and Joint Stock Company. All types of companies existing in Serbia have the status of a legal entity.

There are no requirements with respect to the minimal amount of the share capital of partnership and limited partnership, but since their founders are liable with all their assets for the company's obligations, these types of companies are rarely seen in practice. The new Company Law does not introduce any significant changes to the legal regime of partnerships and limited partnerships, except the possibility for legal entities to be founders of these types of companies.

The most commonly used legal form in Serbia is a limited liability company. The liability of the owners is limited to their share in the company, and they cannot be liable for obligations of the company itself, except if they misuse the company for unlawful or deceptive purposes. A shareholder may have only one share in the company, which is expressed as a percentage. The share capital may consist of cash and contributions "in kind", such as equipment, goods, know-how etc and, according to the new law, work and services. The value of contributions in kind can be assessed by the shareholders themselves. The new Company Law provides that limited liability companies can have from 1 to 50 members, and that the minimum share capital is EUR 500.

There are two types of joint stock companies, closed and open (public) joint stock company, that can be listed and not listed. Currently, there is no developed market for the exchange of shares, and most of the joint stock companies are banks and insurance companies because, according to specialized laws, they have to be established in this legal form. The minimal amount of initial share capital for joint stock companies is significantly higher than the one prescribed for limited liability companies, and amounts to EUR 10,000 for closed, and EUR 25,000 for open joint stock companies.

Foreign persons have the possibility to open representative offices in Serbia. The opening and operation of representative offices is regulated by a special Decree and by the Law on Foreign Trade. Representative offices are registered at a specialized Registry at the Ministry of Foreign Economic Relations. Representative offices are not legal entities and are not permitted to be engaged in commercial activities within Serbia. Representative offices can be used for the purposes of surveying the market and providing assistance in concluding agreements.

Positive signs

- *The new Company Law shows a tendency to facilitate business and to leave owners of companies more freedom to regulate their mutual relations, and relations with the company.*

- *There is a significant decrease in the minimum share capital required for incorporation of limited liability companies, in the new Company Law (EUR 500).*

- *There are no more requirements for employees' representatives in companies' bodies.*

- *Only one founding act (Memorandum of Association) is needed for the incorporation of the company under the new Company Law.*

FIC Recommends

- *There are inconsistencies between the Company Law and other laws that regulate conditions for doing business in Serbia, especially with the Law on Securities and other financial instruments, and the new Law on Registration of Business Entities that will come into force on January 1, 2005. These inconsistencies should be removed by legal amendments.*

- *The new Company Law leaves some legal vacuums and contains unclear provisions. The greatest concern relates to the process of conforming the existing companies with the new Company Law, which has to be carried out within two years from the date when the Law came into force. However, it is not clear whether the old Company Law should be applied during this term and, if yes, in which cases. Judicial practice should interpret all of the unclear provisions uniformly, in a way which will facilitate companies' business, and attract foreign investments.*

Labour Law

The Labour Law came into force in December 2001. It is very free-market oriented and comes as a response to the major economic and social changes which occurred and demand more flexibility in the labour market. The most important feature, is that in comparison with the previous labour regulation, the new law is more liberal regarding employment procedures and termination of employment, thus giving more flexibility to employers.

Employment is established by concluding an employment contract in written form. The Law envisages a basic working week of 40 hours, and guarantees at least 18 days of vacation per year to the employee.

Additional rights can be established by collective agreements, internal acts of the employer or can be directly negotiated between the employer and the employee in the employment contract.

Termination of employment by the employer can be 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. This is deemed to exist, in particular, in the case of unsatisfactory working results, lack of the required knowledge and skills, misbehaviour 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

Negotiating a collective agreement is not mandatory and in case that the employer and the relevant union do not come to an agreement, labour relations can be regulated by an unilateral act of the employer (employment handbook) or through the individual employment contract.

In response to the rapidly changing economic environment, the law makes it easier for employers to hire labour for a definite period. However, the term of such a 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.

Implementation Of The Labour Law

Since its adoption, the Law has been implemented without any serious difficulties. Moreover, this Law has brought much clarity and effectiveness in the labour related matters and procedures, which were previously quite complicated, long and unable to fulfil the expectations of a liberal labour market.

The Law sets rules which are favourable to encouraging employment. By regulating only the core issues, it sets the basic rules for defining the relation between the employer and the employee, while leaving enough freedom for both parties to regulate further details in accordance with their interests.

Perhaps, the only area which still needs improvement is the interpretation of the Law by official bodies, such as the labour inspectorate. These bodies still show a tendency to always interpret the law in favour of the employee. Also, constant education of judges is needed in order to be apt for taking decisions, which are more in accordance with the expectation of a free labour market.

Draft Of a New Labour Law

The FIC had the opportunity to see and comment on several drafts of the new Labour Law.

We find that the proposed drafts do not meet the needs of a free market economy and are not favourable to the further development of the labour market in Serbia. Also, we believe that the implementation of such a law would greatly increase the costs of labour, and that many of the prescribed provisions represent a great burden for the employer.

The FIC is satisfied with the Law which is currently in force and believes that if any changes in the labour legislation are needed, they should be undertaken through amendments of the current law.

Law on bankruptcy procedure

A Law on bankruptcy procedure (Official gazette of the Republic of Serbia No. 84/2004) was adopted on 23 July 2004 by the Parliament of the Republic of Serbia, followed by the Agency for Licensing of Bankruptcy Receiver Law. The Law on bankruptcy procedure will be in full force after 1 February 2005, and it will be applicable for all bankruptcy procedures initiated after that day. The current Law on compulsory settlement, bankruptcy and liquidation will be applicable for all such procedures initiated before 1 February, as well as for procedures in which courts of law have not rendered a decision on selling the assets, or the decision on selling was rendered but not more than 50% of the book value of assets has been sold within six months from the effective day of the new Law.

By the new Law, bankruptcy procedures are improved and it is structured more transparently.
First of all, the new Law prescribes an exact period of time for initiation of bankruptcy procedures, meaning that this procedure has to be implemented against the insolvent debtor. An insolvent debtor is defined as debtor who:

- Can't respond to due obligation within 45 days
- Ceased all payments during the period of 45 days
- Makes probable that its obligations will not be paid
- Was unable to pay its obligations even through court or tax execution procedure

The new Law introduced an Agency for licensing bankruptcy receivers, which was closely prescribed in another law: the Law on Agency for Licensing of Bankruptcy Receiver. The jurisdiction of the new agency is:

- Issuing, renewing and revoking licenses for bankruptcy receivers
- Organizing the license exam
- Keeping the registry of bankruptcy receivers
- Supervising and following development of the bankruptcy receivers profession
- Following the application of regulations on bankruptcy procedures and collecting and processing data on bankruptcy procedures
- Suggesting the standards for management of bankruptcy estates and ethic codes

The Government of the Republic of Serbia has to appoint a Board of Directors, a Supervisory Board and a Managing Director of the Agency within 30 days as of the day of implementation of the Law on Agency.

A new legal institute in the country is a license for bankruptcy receiver which is, upon the Law, compulsory for bankruptcy receivers. It would be issued after a special exam has been passed , it is revocable and subject to renewal and revocation before the Agency for licensing.

Eligibility criteria for bankruptcy receivers are prescribed too, and now a university degree, status of entrepreneur, and a license are required, as well as the absence of any conflict of interest.

The main goal of the new Law is reorganization of the insolvent debtor, in terms of repayment of creditors through an adopted reorganization plan. All involved parties in bankruptcy procedures are entitled to submit a reorganization plan, fulfilling eligibility criteria for adoption. Reorganization plans may include several methods, such as: sale of assets, dissolution of non-profitable organizations units, changing of business activities, write off, conversation of debts and similar.

As per the new Law on bankruptcy procedures, the Assembly of creditors becomes more active in this process, meaning that the Assembly of creditors has the position of a shareholder's assembly. Members of the Assembly are creditors with unsecured receivables, but creditors with secured receivables could also participate in the Assembly, up to the unsecured amount. Voting rights in the Assembly are proportional to the amount of receivables. The Assembly is, among other things, entitled to appoint a Creditor's Committee, which is a body with more active impact into bankruptcy procedures by its instructions, opinions, objections given to bankruptcy receivers and other bodies relevant for this procedure.

Positive signs

Bankruptcy procedures become a legally prescribed way: (i) of recovery of creditors receivables in one hand and (ii) of reorganising insolvent debtors. The new law is dedicated to structuring new legal institutes and to improving existing ones, for the purpose of leading bankrupt debtors from this procedure into a new company, able to respond to its obligations.

FIC Recommends

- *As an essential continuation of this Law, the Law on factoring must be the following one, because selling and purchasing of receivables must become leading instruments for full and satisfactory implementation of the Law on bankruptcy procedures, as we as for developing the entire market.*

- *The appointment of the Agency for licensing the bankruptcy receiver, and the introduction of the procedures of the bankruptcy receiver's exam must be done in as short as possible a period of time, to avoid the situation that we have a good law, but not an implemented one.*

Securities

The new Serbian Law on Securities and Other Financial Instruments Market was adopted in November 2002, but entered into force in September 2003. The Law regulates three main fields; the process of distribution of and trading in securities, the activities of authorised participants on the market and the role of the Securities Exchange Commission (SEC).

Distribution of and trading in securities

Issuing of new shares through public offering

The process is initiated by publishing a public announcement and prospectus on the issuance of new shares, followed by a series of actions required for subscribing and paying for the shares and obtaining the authorisation on issuance of shares from the SEC. It ends with the transfer of shares to the securities account of the new owner.

Trade in securities through the stock exchange

Trade in securities on the stock exchange can be performed only through broker-dealer companies or authorised banks.

Take-over bids

Purchase of more than 25% of voting shares of a company can be carried out only through a take-over bid, which must obtain prior approval of the SEC.

Authorised Participants On The Market

Authorised participants on the market are the Stock Exchange, the Central Registry of Securities, authorised banks and broker-dealer companies and the Custody Banks. The Law provides the general framework for their foundation and operations, and rights and obligations. These issues are more closely regulated through by-laws and rulebooks of the SEC.

Security Exchange Commission

A crucial role and significant power was given to the Commission. The SEC is responsible for, among others, the rules related to the application of the Law, issues licences and supervises the operations of authorised participants in the market, sets standards for registration of stock exchange trade operations, establishes contents of mandatory information that is to be submitted to it and published, monitors the state of and trends in the securities market and undertakes corrective actions.

Application Of The Law

Since the Law entered into force, the SEC has been very active in its role as regulator of the securities market. Many by-laws on various procedures were adopted and/or amended. The closer regulation of these areas brought more understanding of the process. Also, many official opinions were issued by the SEC, explaining many questions, which have arisen during the implementation of the legislation.

However, on many occasions, the legislated solutions didn't show sufficient clarity, and led to many misunderstandings and ambiguous situations, or were not harmonized, while other issues remained completely unregulated. For example, the procedure of homogenization of shares represents a long and complicated procedure, due to lack of legislation, on one hand, and non-harmonization of rules between the Stock Exchange and the Central Registry of Shares, on the other.

Bearing in mind the fact that the privatization process is in its final phase, take-over bids gained importance over the past year and became one of the main investment modalities. However, this transition did not pass without certain troubling events, which were, among others, the consequence of lack of experience of competent bodies in dealing with arising issues.

No specific difficulties were encountered in the process increase of capital and issuance of shares.

Positive signs

- *The Law is currently being implemented without greater difficulties, after the uncertainty which was present in the first months after its coming into force.*

- *The intent of regulating the securities market based on a contemporary model was successful to a great extent, even though improvements are still necessary.*

FIC Recommends

- *Harmonization of the Law on Securities and Other Financial Instruments Market with other relevant legislation (including new Company Law and the Rules of Procedure of the Stock Exchange) is necessary.*

- *Introduction of more precise and harmonized procedural solutions are necessary in order to prevent troublesome situations from arising again.*

- *The very onerous and strict rules of procedure, for obtaining the different and numerous approvals of the SEC, should be simplified.*

- *Even though changes of the rules are necessary in certain cases in order to ameliorate the conditions on the market, we believe that the timing for introducing such changes should be well chosen - rules of procedure should not be changed when a procedure has already been initiated.*

- *In the expectation of further development of the market, closer regulation of financial derivatives is needed.*

Intellectual Property

Intellectual property (IP) rights are protected and regulated at the level of the State Union of Serbia and Montenegro. The relevant institution granting these rights is the Agency for Intellectual Property, located in Belgrade. In Serbia and Montenegro, the following IP rights are protected: patents, designs, trademarks, indications of the geographical origin, topographies, plant varieties, undisclosed information and copyright and related rights. All of these rights are regulated and protected by separate laws.

Positive signs

In order to harmonize IP rights in Serbia and Montenegro with the relevant provisions of the WTO expressed in the TRIPS Agreement, International Conventions and EU Regulations and Directives, a general reform of this sector was commenced in 2003. To that end, in July 2004 the new Patent law was passed and came into force. This Law is fully harmonized with the above mentioned legal sources. The Trademark Law and Design Law are in the form of the final draft, entering the parliamentary procedure in the Parliament of State Union of Serbia and Montenegro. The other relevant laws are also entering into the stage of the final draft and it is quite reasonable to expect that they would be passed during the first half of 2005.

Once all of the relevant laws regulating the protection of the above mentioned IP rights in Serbia and Montenegro are passed and come in to force, there will be a fully harmonized legal system of regulation and protection of IP rights, attractive for foreign investors and providing full legal security for the protection of their rights. At the same time, the harmonized legal system of protection of IP rights is necessary for entering into WTO Agreements and will be a positive step in the process of accession and stabilization with the EU.

The Copyright law was passed by the Parliament of the State Union in December 2004.

FIC Recommends

- *The next task that the relevant authorities have to address is the issue of enforcement of the protection of the above mentioned IP rights, which means that there should be an appropriate protection of these rights in court procedures and the improvement in the functioning of the*

Agency for Intellectual Property. The current judicial system should be reorganized and separate departments should be established to deal only with intellectual property rights problems. The cooperation between the courts and the police is of substantial importance, since the struggle against organized crime and pirate producers can be successful only if that cooperation is continuous and intense.

- *The protection of IP rights is the most important IP issue for a foreign investor in Serbia and Montenegro. It is important to introduce more severe sanctions, such as amendments to the penal code for violation of IP rights, discouraging piracy or other forms of infringement. This will require a reorganization of the current judicial system, by establishing a separate department in relevant courts specializing in IP cases. A strong media campaign is necessary in order to educate the general public on the main IP issues and to create an atmosphere rejecting violations of IP rights.*

Court System

Organization of Courts

The new Law on Organization of Courts enacted in 2001 regulates the organization of the court system in Serbia. Nevertheless, the provisions of the old Law on Courts, regulating jurisdiction of courts, shall remain in force until 2007, and the provisions of the new Law shall be applied as from 2007 due to non-fulfillment of material preconditions for its implementation.

The court system consists of:

- The constitutional court
- Courts of general jurisdiction
- Courts of special jurisdiction

Courts of general jurisdiction are the following: the Supreme Court, appellate courts, county/district courts and municipal courts. The courts of specific jurisdiction are the following: commercial courts, Higher Commercial Court and Administrative Court.

The Supreme Court is the highest court in Serbia and acts as the court of second instance to the Higher Commercial Court and the Administrative Court. It is the final court of appeal for all decisions that do not relate to constitutional issues.

Appellate courts are the new institutions introduced by the Law on Organization of Courts in 2001. They are to be second instance courts to municipal courts and county/district courts. The formation of appellate courts is postponed until 2007.

County/district courts are established to cover the territory of a county/district. In some matters, they are courts of second instance to municipal courts, and in others, they act as courts of first instance.

Municipal courts are usually courts of first instance and are established to cover one or more municipalities. For example, there are 5 municipal courts in Belgrade covering 11 municipalities. The jurisdiction of municipal courts covers all matters not relating to commercial issues.

Commercial courts adjudicate commercial matters and the Higher Commercial Court is the second instance court for these matters.

The Administrative Court is a new institution introduced by the Law on Organization of Courts in 2001 for adjudicating administrative matters. Formation of Administrative Court is postponed until 2007.

The Constitutional Court of Serbia and Montenegro has the authority to rule on the legality and constitutionality of laws enacted by the Parliaments and of government and executive actions. The Court is entitled to order the repeal of laws, with or without retroactive effect. The Court may be accessed directly by anyone, but cases are usually brought to the Court through a lower court or during the legislative process.

The developments in 2004, which have impact on the court system are the adoption of the new Law on Civil Procedure and the new Law on Enforcement Procedure. These two laws will come into force three months upon publishing in the Official Gazette (February 2005).

The new Law on Civil Procedure gives more importance to the preparatory hearing, and prescribes that parties shall provide the court with all the facts and proofs they will present at the main hearing. Due to this, and any other important changes, it is expected that the application of the law will make the court procedure more efficient.

The adoption of the Law on enforcement procedure is a big step in the process of reform of enforcement procedures. With the introduction of the new Law, the procedure of enforcement of court decisions is accelerated, legal certainty improved and impetus for more efficient functioning of financial markets provided.

FIC Recommends

- *Systematic and continuous education of judges, particularly on the application of the new procedures, is necessary.*

- *Better organization of courts is essential. Namely, the new Law on Organization of Courts envisages solutions, which will positively influence faster and more efficient solving of court cases once applied. Therefore, serious preparations for the implementation of this law are necessary prior to its moment coming into force.*

- *The adoption of the Law on Civil Procedure and Law on Enforcement Procedure represents an important step in the reorganization of the Court system in Serbia. Still, a certain period of implementation should pass before giving any evaluation of the effect these two laws shall have on the whole legal and court system.*

Chapter 5

Privatisation

An overview of the privatisation process in Serbia from 2002

The privatisation process in Serbia is defined by the Law on Privatisation (Official Gazette no 38/01 and 18/03) and is mainly based on the model of direct sale, whereby up to 70% of the shares of the firm are sold either in tender or public auction to a private buyer. The process was launched in 2001, while the first tangible results were achieved in 2002, when the total price of EUR 261 million and additional investment and social welfare commitments of the buyers amounted to EUR 320 and 140 million respectively. Furthermore, minority government holdings in 87 firms were offered for sale, of which 48 sales were successful and generated a total price of EUR 81 million.

The privatisation process in Serbia almost tripled its speed in 2003 in all the segments. A total of 696 privatisations were completed via tender and auction procedures (the success rate is 85%), while 121 minority packages held by the government were sold to the private buyers via the capital market. The total generated privatisation receipts of EUR 947 million in 2003 exceed the projections by far[1].

In 2003, a total of 49 enterprises were offered through tender sale. Of these only 22 (as opposed to 12 in 2002) were successfully sold, mainly to foreign buyers. The total sale price realized an amount of EUR 605.5 million (which is three times amount realised in 2002) while the additional investment and social commitments amounted to EUR 330.8 million and EUR 129.8 million. The privatisation champions in 2003 were Beopetrol and two tobacco factories in Vranje and Nis to Lukoil, British American Tobacco and Philip Morris International. These three tender sales realised 63% (EUR 554 million) of the total sales price, realised in both auction and tender sales in 2003.

Out of 773 enterprises that were offered via auction procedure in 2003, 674 were successfully sold, which is more than three times the number of enterprises auctioned off in 2002 (which was 205). The total sales price realised was EUR 274 million with additional investment commitments of EUR 61.7 million made by the buyers.

Aggregate data on privatization, total revenue, investment and social commitments during 2004 is not available yet. According to preliminary data obtained from the Agency for Privatisation (by 16 November 2004) 257 companies were sold in tender and auction sale in 2004 generating a total price of EUR 107.5 million as well as additional investment and social welfare commitments of EUR 102 and 2.5 million respectively. Additionally, 31 companies were sold via capital market, generating a total price of EUR 137 million. Most companies were sold to domestic natural and legal persons. The same source observes that 60 large conglomerates are in the restructuring process.

The pace of privatization in 2004 compared to 2003 is much slower. During 2004, small and medium, i.e. the least problematic enterprises, were targeted. In that sense, privatisation of large socially and state owned companies is pending, that is to say is expected, in the forthcoming year, particularly

[1] *Source: IMF country Report 03/296 of September 2003.*

bearing in mind that the Law on Privatisation clearly sets the deadline for ending the privatization process of all socially and state owned companies, which is mid 2005.

Positive signs

According to the Agency for Privatisation, the amendments to the Law on Privatisation are in the phase of preparation, most of which relate to more detailed regulation of the process of restructuring in privatisation. In relation to that, and in line with WB and IMF guidelines, it is anticipated that the largest state owned enterprises undertake a restructuring process: Electric Power Industry of Serbia (EPS), NIS - Petroleum Industry of Serbia, Railway Transport Company (ZTP), PTT Post, Telecommunications state owned duopoly (Telekom), Srbijasume, Srbijavode, Producer of electronic devices (EI NIS), Yugoslav Airlines JAT and Belgrade Airport. The largest state owned companies, including the public power utility EPS and petroleum producer NIS, will be privatised last, but not before 2005. The main idea is vertical disintegration of large state owned companies and subsequent privatisation of some of its parts.

In light of anticipated finalisation of the privatisation process in Serbia, three new Laws may be identified as a contributing factor to soon ending the social and state ownership. The adoption of the Law on Bankruptcy Procedure, and recent passage of the Law on Civil Procedure and the Law on Enforcement Procedure, creates the legal framework providing for better and more efficient procedure for the protection of creditors. These laws will have a significant impact on the final stage of the privatisation process.

Furthermore, the Law on Bankruptcy Procedure together with the new Company Law will reinvigorate the restructuring of large conglomerates and utilities, and foster the creation of plans for selling the assets of bankrupt companies.

FIC Recommends

- *Harmonisation of regulations on securities and the financial markets.*
- *The ownership of urban construction land should be enabled for foreign entities*
- *The land registries should be updated.*

Chapter 6

Taxation

A. Taxation of corporations

Tax Residents

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

Taxable persons

A taxable person includes 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 selling goods and services.

Tax rate and tax base

As of 1 August 2004, the tax rate is 10% and the tax year is the calendar year. The tax base is determined by adjusting the taxpayer's accounting profit before tax is determined according to IFRS (from its profit and loss account) and in accordance with the Corporate Income Tax Law.

Areas where tax adjustments may arise include:

- Inventory (valued at average cost or FIFO method)
- Costs of employment (e.g. salary, social security contributions): fully deductible excluded severance payment calculated but not paid out
- Depreciation; allowances are granted for intangible long-term assets, tangible fixed assets understood as tangible fixed assets which useful life is longer than one year, and whose purchase price is higher than average gross wage on Republic level at the time of purchasing. All tangible fixed assets are classified in five groups, according to the depreciation rates. The straight-line method applies to the purchasing price of fixed assets classified in the first group (separately on each asset) and declining balance applies to the whole group value for those classified in the remaining four groups
- Reserves and provisions: write off for specific doubtful debts is tax deductible only if it is documented that collection was attempted through the Court, while provisions are tax deductible upon expiring 60 days from the due date
- 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

Thin capitalization

Interest paid to a related company which exceeds four times share capital and reserves multiplied by 110% of the interest rate of the Central Bank of the lender's country is not deductible. The excess may be carried forward.

Transfer pricing

A company must identify transactions with related companies and compare them with arm's length transactions when filing its tax return. Credit relations between associated companies are compared with credit conditions in the market. Any unexplained differences are included in taxable income.

Fundamental mistakes

Income or expenses caused by fundamental mistake or changes in accounting policy that are not presented in financial reports for the period of their arising should affect the financial report for the year of their arising

FM is the mistake defined by IFRS that changes taxable profit/loss by more then 2%.

Tax Incentives

There are a number of incentives intended to attract investors to certain sectors and designated areas and to promote employment.

Tax Holidays

A proportional tax holiday of ten years is available for a taxpayer who makes an investment in tangible fixed assets of at least CSD 600 million and creates additional employment for at least 100 employees during the investment period. The tax holiday begins when these two conditions are met but only from the first year in which taxable income is generated.

The tax holiday is proportional based on the ratio between the investment concerned and total fixed assets after the investment. Until the conditions for the tax holiday are met, the taxpayer is entitled to the tax credits mentioned below.

Only new fixed assets purchased in Serbia or imported fixed assets (new or second-hand) are recognized for the holiday. It is not clear whether fixed assets provided as a contribution in kind are eligible.

New employees are not required to be unemployed prior to employment with the taxpayer to satisfy this need.

If a condition for the tax holiday is breached during the holiday period, the taxpayer will lose the holiday.

The taxpayer must pay the tax saved, increased by the relevant inflation rate.

A five-year tax holiday exists for companies investing at least CSD 6 million and employing a minimum of five workers in underdeveloped regions.

Profit earned on the basis of a concession is tax exempt for five years.

Tax credits

A taxpayer who employs additional staff previously registered as unemployed is granted a tax credit for the value of their gross salaries. The tax credit is granted for employments performed in that taxable year.

A company which acquires fixed assets may reduce its tax liability by 20% of the investment, but the

reduction may not exceed 50% of its total tax liability. A small company may decrease its tax liability by 40% of the investment, but the reduction may not exceed 70% of its total tax liability.

Companies registered in particular activities such as agriculture, fishing, types of textile production, production of motor vehicles, machines, medical equipment etc. when acquiring fixed assets may reduce its tax liability by 80% of the investment.

Unused credits for investment in fixed assets may be carried forward for ten years and offset against future tax liabilities.

Accelerated depreciation

Accelerated depreciation is allowed in respect of some fixed assets associated with ecology, scientific research and education as well as computer equipment. Accelerated depreciation rates are up to 25% higher than rates prescribed by the Corporate Income Tax Law.

Employment of Disabled Persons

The tax liability for companies employing disabled persons is decreased in proportion to the percentage of such persons to the total number of employees.

Exemptions

Non-profit organizations have special rules for tax exemption.

Groups of Companies

Companies are considered a group if one company controls 75% or more of the shares of another.

A group has the right to tax consolidation if all companies are Serbian residents. Each company files its own tax return and the parent company files a consolidated return for the entire group.

In the consolidated return, losses of one or more companies are offset by the profits of other companies. Each company is liable for tax proportional to its share of the profit of the group.

Withholding taxes

Withholding tax at the rate of 20% is levied on dividends, shares, interests, royalties, capital gains, income generated from renting movables and immovable paid to a nonresident.

An applicable double tax treaty may reduce withholding tax rates.

Losses

A company can carry loss forward for ten years.

Assessment and collection

Corporate tax is payable in monthly advance installments by the 15th of the following month, based on the tax liability of the preceding year using the self-assessment method.
The tax return and tax balance sheet must be filed by 10 March of the following year. Taxpayer establishes his monthly advance tax obligation in the tax return based on the tax balance and estimation of future year income/losses.

Developments on 2003

While there have been a few positive signs since publication of the first edition, there has been limited progress during this period.

Positive signs

- *Serbia develops a market orientated and attractive tax system, reflected in a low tax corporate tax rate and investment incentives.*
- *Corporate tax law is harmonized with IFRS.*
- *The establishment of the large taxpayer unit is beneficial for taxpayers associated with this unit;*
- *The Ministry of Finance improved regulations associated with the ten-year tax holiday;*
- *There are a number of examples of tax inspectors adopting a responsible and more educated approach when conducting audits of taxpayers.*

FIC Recommends

- *Taxes other than corporate tax which a company has to pay (e.g. property taxes such as public land use charge and tax on transfer of absolute rights, company name disclosure fee, charge for water use and protection, charge for protection and improvement to the environment, mineral raw material use charge) should be reduced and simplified.*
- *Many investors have a financial year other than the calendar year. However, the authorities will not register a company for a financial year-end other than 31 December. The authorities should revise their practice.*
- *Clarification of Permanent Establishment (PE) regulations is required e.g. the registration of PEs with the Tax Authorities, payment of tax.*
- *The limited deductibility of advertising costs should be reconsidered. The limited deductibility is more applicable to entertainment costs than advertising.*
- *Draft legislation should be submitted to FIC / other appropriate forums for comment before being finalized.*
- *The new government should continue with the development of a market oriented and attractive tax system.*

B. Taxation Of Individuals: Personal Income Tax

Personal income taxation in Serbia is carried out on two separate levels: when income is earned and on the annual level, on the total worldwide income.

Resident vs. Non-Resident

Tax residents are taxable on worldwide income, while non residents are taxable only on the income derived from Serbian sources.

For tax purposes, a tax resident is a natural person that fulfils the following criteria:

- If he/she is present in the territory of the Republic of Serbia for more than 183 days in the period of 12 months
- If he/she has a habitual abode or centre of vital interests on the territory of Serbia

Taxation Of Serbian Source Income

Serbian source income comprises: employment income (salaries), income from agriculture and forestry, income from self employment, income from royalties, income from real estate (lease), income from capital derived in the territory of Serbia, as well as other personal income. The rate is 14% or 20%.

Amendments of the Law for 2005 - tax rate for income from self employment will be reduced to 10%.

Taxation Of Salary

Subject to salary tax on a monthly level is only salary paid by local employer. Salary earned abroad, i.e. paid by foreign employer is exempt from salary tax, but is taxable on the annual level.

According to the tax legislation income derived from employment in Serbia is subject to salary tax, at the rate of 14%. Salary tax is withheld at the source, when the salary is paid. The employee is the taxpayer, but the employer is responsible for calculating and paying salary tax.

The taxable base is the gross salary, which includes salary tax and social security contributions. Fringe benefits are considered as part of gross salary and are subject to salary tax and social security contributions.

Changes of the Law which will be effective in 2005 - to apply salary tax on compensation received based on Contract on Temporary and Occasionally engagement.

Also, in 2005 the taxation of the use of company cars for private purposes will be implemented. The tax base would be 1% of the market value of the car.

Thus, amendment of the Personal Income Tax would encompass changes of employment income that will also include the premium paid by the employer on behalf of employee, related to voluntary pension insurance. A premium in the amount of 3,000 dinars should be tax exempt.

Social Security Contributions

Compulsory social security contributions are calculated and withheld by the employer from the remuneration paid to the employee. There are three kinds of social security contributions: pension and disability insurance, health insurance and unemployment insurance. All three kinds of contributions are payable by the employer and employees at equal proportional rates. The rates of social security contributions are as follows:

- Pension and disability insurance 11%
- Health insurance 6.15%
- Unemployment insurance 0.75%

The amount of payable social security contributions is limited to the amount due for five average gross salaries i.e. in the case the monthly salary exceeds five average gross salaries, social security contributions are not increased.

Annual Income Tax

Taxpayer

Tax residents are liable to pay annual income tax on the total net income earned worldwide. Worldwide income consists of the total net income earned in Serbia and total net income earned worldwide, during the calendar year.

Income subject to annual income tax includes income derived from employment, as well as income from other sources.

Tax Rate

Annual income tax is levied in addition to the salary tax paid during the year. It is levied at the rate of 10%.

Taxable Base

Annual income tax is levied on the total net income earned by tax resident in the calendar year. Only the portion of total net income above the non taxable amount is taxable. The non taxable amount is established by the law and is adjusted on an annual basis, based on the salary growth rate.

The non taxable amount for foreign nationals is substantially higher than the non taxable amount for local citizens.

According to the recent changes of the Law, related to the income earned in 2004, the non taxable income would be as follows:

- non taxable amount for foreign nationals is set at tenfold the amount of the average annual salary in the Republic
- for local citizens, the non taxable income is at fourfold the amount of the average annual salary in the Republic.

In accordance with changes to the non-taxable level, personal allowances will be as follows: basic allowance for taxpayer in the amount of 40% of the average annual salary in Republic and 15% of the average annual salary for dependent member of their family.

Tax Assessment and Collection

Annual income tax is established by the tax authorities, based on the data included in the annual income tax return. The deadline for filing the tax return is 15 March for the income earned in the previous calendar year.

The tax is assessed based on the data in the tax return. Once established by the tax authorities, the tax has to be paid within 15 days from the day when the tax assessment is received by the taxpayer.

Taxation Of Expatriates

Tax Exemption Granted to Foreign Nationals

Fringe benefits received by a foreign national-resident from his local employer, are exempt from salary tax in the amount equivalent to 35% of local salary paid to a foreign national.

To benefit from tax exemption, local employment of a foreign national in Serbia should not exceed three years. After three years of local employment, the foreign national is no longer entitled to tax exemption on fringe benefits.

Social Security Contributions of Expatriates

The status of expatriates regarding social security insurance depends on whether the country of the origin has signed the Social Security Convention with Serbia and Montenegro or not. The purpose of this Convention is to avoid double payments of social security contributions by citizens in the countries involved. Provided that expatriates are covered by recognized social insurance, they do not have to pay local social security contributions in both countries.

Comparison with 2004

As of 1 July 2004 social security contributions rates were increased from 16.8% to 17.9%, and payroll tax was abolished from the Serbian tax system.

The threshold for annual income tax for foreign nationals has been decreased.

Positive signs

- *The main purpose of proposed changes of the Law on Personal Income Tax is to decrease the tax burden on the economy and taxpayers*

- *Tax exemption and a lower tax rate are created to encourage foreign nationals*

FIC Recommends

- *To finally solve the question regarding payment of social security contributions for expatriates with whose countries Serbia has a Convention regarding payment of social security contributions*

- *Income from abroad - no need for fines and penalties if that income is submitted in the annual income tax statement*

- *To ease procedures between Ministry for Interior and other authorities*

- *To keep existing trash hold for expatriates*

C. Indirect Taxes

Sales Tax

Until December 31, 2004 a 20% single stage Sales Tax was applicable on the import and domestic sale of goods and a cumulative multi-stage Sales Tax was applicable on services.

Value Added Tax

With effect from January 1, 2005, a new VAT Law came into force replacing the old Sales Tax Law. VAT is a multi-stage turnover tax payable at all stages of turnover of goods and services, as well on import of goods.

Taxpayers

Taxpayers of VAT are all legal entities and entrepreneurs who in the previous 12 months of business operations had turnover of goods and services in excess of CSD 2,000,000 (app. EUR 26,000) or who predict that they will have turnover higher than the above amount. Registration of an entity as a VAT taxpayer requires submission of a registration tax return (EPPDV tax form) to the Tax Authorities.

A taxpayer is generally a person that sells goods and services or an appointed agent of a foreign legal entity. If a foreign legal entity has not appointed an agent to pay tax on a taxable supply, the taxpayer is the recipient of the goods or services.

Taxable base

The taxable base for VAT purposes is the fee for sold products and services exclusive of the VAT to be charged. The taxable base should also contain Customs Duties, Excise Tax paid, transportation and insurance costs or any other cost relating to the sale of goods and services, but should exclude any discounts granted at the time of sale.

Tax point

The VAT liability arises on the first day of any of the following events occurring:

- Sale of goods and services;
- Collection, if the fee or a part of the fee has been collected prior to sale of goods and services;
- On the date of the origin of Customs Duties, in case of the import of goods.

Input and output VAT

Input VAT is the VAT calculated and paid by a taxpayer to its supplier upon purchase of goods and services. Output VAT is the VAT which a taxpayer charges and collects on goods and services provided to customers.

Determination of VAT obligation

Taxpayers are generally entitled to offset input VAT (VAT paid upon purchase of goods and services) against output VAT (VAT calculated on goods and services provided to customers) when determining the amount of VAT payable to the Budget.

However, input VAT paid to supplies on certain products and services (such as cars, motorcycles, representation costs, hotel accommodation, meal costs, home electric appliances, etc,) cannot be deducted against output VAT. As discussed in further detail below certain other types of specific activity also preclude the recoverability of input VAT.

Any excess amount of recoverable input VAT paid that cannot be fully offset against output VAT can be generally carried forward as a tax credit and offset against future VAT obligations or the taxpayer has the right to claim a refund, in which case the overpaid amount of input VAT should be refunded within 45 days or 15 days for exporters.

Tax rates

The tax rates prescribed by the VAT Law are the following:

- Standard VAT rate- 18%;
- Lower VAT rate- 8%
- Exempt supplies with and without the right to recover input VAT.

The standard VAT rate is applicable for most taxable supplies. However, the lower VAT rate applies on turnover which includes the following goods and services:

- Basic food stuffs (bread, milk, sugar, vegetable oil, fresh meet, eggs, fruits and vegetables);
- Daily newspapers;
- Communal services, etc.

In addition to the above tax rates, a VAT exemption is also applicable. By way of example, a VAT exemption with the right of recovery of input VAT applies to turnover which includes the following goods and services:

- Export of goods;
- International air transport;
- Transport services related to exports of goods and temporary import;
- Services performed on temporarily imported goods, etc.

A VAT exemption without the right of deduction of input VAT applies to turnover which includes the following goods and services:

- Trading with shares and other securities;
- Typical banking services;
- Insurance and reinsurance;
- Turnover of land;
- Lease of apartments and business premises; etc.

Reporting period

The new VAT Law has determined two reporting periods:

- Each calendar month for taxpayers whose turnover in the previous 12 months was over CSD 20,000,000 or who predict that turnover in the next 12 months will be above the CSD 20,000,000 threshold; or
- For taxpayers whose turnover does not exceed the above CSD 20,000,000 threshold, the reporting period is three months.

Tax return PPPDV should be submitted within 10 days of the previous tax reporting period.

Excise Tax

Excise duties are levied on turnover of the following products:

- Oil products,
- Tobacco products,
- Alcoholic and soft (carbonated) drinks,
- Imported non-alcoholic beverages (fruit juices and syrups);
- Coffee.

It is charged as a fixed fee per unit of the product as follows:

- Petrol fuel 27,50 CSD per liter;
- Diesel fuel 15,66 CSD per liter;
- Beer 8,00 CSD per liter;
- Whiskey 126,00 CSD per liter, etc.

With effect from January 1, 2005, a special excise regime was imposed on production and import of cigarettes as in the following examples:

- Domestically produced cigarettes 10 CSD per pack + 30%;
- Imported cigarettes 1 CSD per pack + 30%;

Excise duty is payable by the producer or importer of products at the moment when an excisable product is dispatched from the factory, or when the goods enter into the Customs Area of the Republic of Serbia upon import.

Customs Import Duties

Import of most goods is subject to customs import duties in addition to VAT (n.b., upon import of excisable products, Excise Duty is also payable).

Customs import duties and taxes are payable by the importer. Import duties are charged based upon the rates prescribed by the Customs Tariff.

The average customs rate is below approximately 10%, as generally most goods are subject to customs duties ranging from 1-10%. The highest tariff rates (between 20-30%) are applied to agricultural products. The import of certain agricultural and food products is also subject to agricultural administrative charges.

Licenses are required for import/export of certain goods, such as agricultural products, drugs and precious metals. Such licenses are issued by the relevant Ministry.

Import regimes

Goods can be imported under both regular and temporary import procedures.

A regular import procedure implies that the goods are customs cleared for free circulation, i.e. duties are paid at the border. After the completion of the customs procedure, imported goods acquire the status of domestic goods and can be freely disposed of on the territory of Serbia.

A temporary import procedure is a special procedure where the customs authorities approve the import of goods with partial or complete exemption from customs duties, provided that such goods leave the country in their original condition within a specified period of time, which is requested by the importer and approved by the Customs Authorities. Temporary import is granted with a complete or partial exemption from customs duties, as prescribed by the Government. Such goods cannot be disposed of or traded on the territory of Serbia without being customs cleared first, and the entire amount of customs duties paid.

A customs processing regime also exists within the temporary import process where goods can be imported for overhaul and refurbishment and then exported back to the country of origin.

Customs Export Duties

No customs duties are levied in respect of the export of most goods. However, for export of certain specified products an export Customs Duty is prescribed under the Customs Tariff Law. By way of example, the following products are subject to customs export duties:

- Aluminum 15%;
- Metal scraps 15%;
- Raw leather 20%, etc.

Customs Processing Fees

Several nominal processing fees are charged by the Customs Authorities upon import and export clearance. These largely immaterial fees are based upon time spent by customs officers, processing of declarations, applying customs stamps, etc.

Free zone

Free Trade Zones may be established by domestic or foreign legal and natural persons, subject to obtaining authorization from the Federal Government. A minimum 30% of goods and services produced/supplied in the zone should be exported.

Export and import of goods and services from/into Free Trade Zone is free. The import of the goods to be used in business activities in the Free Trade Zone is exempt from customs duties and other import charges. The sale of goods produced in a Free Trade Zone and sold on the territory of Serbia is subject to import duties.

Tax on financial transactions

With effect from January 1, 2005, Tax on Financial Transactions, which was previously imposed on every financial transaction (with certain exceptions such as payment of salaries, taxes, etc.) of a legal entity at the rate of 0.22%, was abolished.

Positive signs:

- *The introduction of VAT;*
- *Abolishment of Tax on Financial Transactions;*

FIC Recommends:

- *Ongoing training in VAT regulations for Tax Officials and an increase of VAT specialists in the Tax Authorities;*
- *Regular updated publication of new legislation and Tax Authority interpretations regarding the application of the VAT Law;*

- *A pro-active approach from the Tax Authorities in helping companies to address "grey areas" in the VAT legislation as it evolves;*

- *Successful implementation of regional Free Trade Agreements and movement towards signing a multilateral agreement;*

- *Creation of a single customs area between Serbia and Montenegro.*

Chapter 7

Accounting and Auditing

The Law on Accounting and Audit is based on The Official Gazette No. 71/2002 dated 26 December 2002

International Accounting Standards

The implementation of International Accounting Standards (IAS) has been obligatory for all legal entities; for Banks, from 1 January 2003, and for other companies, from 1 January 2004.

Annual Financial Statements

Annual financial statements should comprise the following documents:

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

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

Submission of Financial Statements

Only Annual Financial Statements must be prepared (as at 31 December) and submitted to the NBS

Legal entities must submit their financial statements as follows:

- Annual Financial Statements by 28 February
- Consolidated Financial Statements by 31 March
- Approved Financial Statements together with the auditor's opinion by 30 June

Additionally, all companies requiring audit (see below) are requested to publish their financial statements together with the auditor's opinion on their website at least seven months after the B/S date. However, there are two exceptions to the rule relating to the preparation of Annual Financial Statements at 31 December:

- Foreign company subsidiaries, for which the financial year differs from the calendar year. Such companies may prepare and submit their Financial Statements coterminous with the financial year of the Parent company. However, approval from the Ministry of Finance shall be obligatory.
- Entities undergoing a change of status for example merger, liquidation or bankruptcy. Such entities are required to prepare their financial statements at the date on which the procedure is completed.

Audit Requirements

The Annual Financial Statements audit for big and medium-sized companies is obligatory although the requirement for medium companies is effective from 1 January 2004. A rotation of medium-sized company auditors is compulsory every five years while the rotation of large company auditors is required every three years.

Chart of Accounts and Accountants

Records must be kept in accordance with the prescribed Chart of Accounts. The Ministry of Finance has prescribed the New Chart of Accounts and released it in May 2004. This New Chart of Accounts shall be applied to opening balances and transactions as of 1 January 2004.

For tasks such as keeping the book of accounts, preparing and presenting Financial Statements, all Legal Entities are requested to engage professional staff holding certification.

The New Chart of Accounts has been designed to provide classifying, recording, measuring and presenting transactions and balances in accordance with IAS and International Financial Reporting Standards (IFRS) requirements.

The Provisional Regulations of the Rules on the Chart of Accounts, incorporated as Article 77 of the said Rules, prescribe ways of transferring balances from old to new accounts as well as ways of making reclassifications and accounting adjustments where necessary.

The New Chart of Accounts also prescribes the accounting treatment of certain balance sheet items in opening IFRS balance sheets subject to the reconciliation of equity as at 1 January 2004 and the reconciliation of the relating profit and loss.

Legal entities shall not be required to prepare comparative figures in accordance with the IFRS for the year 2003, thus, the first Financial Statements in accordance with the IFRS shall be prepared for the year 2005.

Additionally, The Ministry of Finance has prescribed the format of Financial Statements comprising of the following documents:

- Balance Sheet,
- Income Statement,
- Cash Flow Statement, and
- Statement of Changes in Equity.

The same format is prescribed for statistical purposes.

Company size

Classification criteria

Medium-sized companies:
1) Average number of employees: 50 - 250;
2) Annual total income: EUR 2,500,000 - 10,000,000 in CSD equivalent; 3) Average property value: EUR 1,000,000 - 5,000,000 in CSD equivalent.

Small companies:
if the value of at least two of the above criteria is lower than that mentioned.

Big companies:
if the value of at least two of the above criteria is higher than that mentioned.

Requirements for Preserving Records

• salary records containing important employee information	Permanently
• financial statements	50 years
• the general ledger	10 years
• supporting documentation	5 years

Financial institutions are obliged to keep data on payment clearance for 5 years.

Comparison with 2003:

- The Minister of Finance has established an Accounting and Audit Committee the task of which shall be to keep an eye on the implementation of Accounting and Audit Regulatory Rules
- The Minister of Finance has passed a Decision on the translation of the IASs (The Official Gazette 133/2003 of 31 December 2003). The translation of IFRS 1 - First-time Adoption of International Financial Reporting Standards - has been published (The Official Gazette 6/2004 of 21 January 2004). The said translations have been used as accounting training material in 2004 and as material based on which the New Chart of Accounts has been prepared.
- The Ministry of Finance has passed onto the Parliament of Serbia a Draft on the Amendments to the Law on Accounting and Audit. However the Draft will only be considered in the first half year of 2005.

Positive signs

- *The fast implementation of IAS is a key step toward transparency and will certainly facilitate foreign investment*

- *The implementation of IAS will position Serbia ahead of other countries in the region in regard to the accounting framework*

FIC Recommends

- *Implementation of IAS implies and requires significant training and a high degree of knowledge, which is not found in Serbia at present. Tax authorities, finance department staff and professional organizations lack a thorough knowledge of IAS.*

- *The role and independence of auditors needs to be debated and clarified by the relevant Authorities.*

- *The Ministry of Finance needs to give approval to foreign company subsidiaries for which the financial year differs from the calendar year, to prepare and submit their Financial Statements coterminous with the financial year of the Parent company.*

Chapter 8

Labour and Public Administration

Availability of labour

The Serbian 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 compared with 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.

Working Hours

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

Social Security

The Serbian 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.

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.

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 Serbia 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 either:

- Intending to conduct activities in the area of foreign investment or international trade, according to domestic law
- 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. People 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 there is no need to giver a reason. 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 undertaken 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.

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.*

Chapter 9

Financial/Banking Sector

Training of compliance auditors

Current situation

NBS is the main supervisory body for the local banking industry. Their main operations consist of adopting of by-laws, daily consultation with banks and on-site inspection of their operations.

Positive signs

NBS had made efforts to change the general mission of the supervision function from criteria compliance watchdog towards risk monitoring institution. Initiation efforts have been made for the establishment of the Finance Academy. The establishment of the Bank Compliance Officers Association has been initiated with the emphasis on the anti money laundering.

FIC Recommends

- *In order to promote this orientation shift of the supervision function, it is our opinion that the necessary further step would be the training of the NBS's compliance auditors.*

Role of the Banking Association

Current situation

The Serbian Banking Association is the banking industry group established to provide support and represent the interests of its members towards the government, central bank and other institutions.

Positive signs

Representatives of the foreign capital local banks are currently represented both in the Managing Board and operating committees of the Association, where they are in position to present standpoints of the banking industry segment.

FIC Recommends

- *The Serbian Banking Association should take a more proactive role in the creating the bank favorable environment that would not limit the growth of the industry itself, but would promote it.*

Treatment of Share Capital of Banks

Current situation

According to the Article 9 of the Law on securities and financial markets, the legal entities can only issue shares in local currency. Regarding debt securities, the only possibility to issue foreign currency denominated paper is prior approval of the NBS.

On the other hand, the required minimum amount for share capital for establishment of a bank is set at EUR 10 million. Additionally, there is requirement of the NBS for commercial banks to maintain the level of share capital above the minimum throughout their operations.

In the case of initial capital contribution made in foreign currency, share capital would be defined in domestic currency and be subject of possible future negative influences of local currency devaluation. The cumulative nominal CSD depreciation towards EUR in 2003 and 2004 of 28.2%, with no additional share issue in the meantime, is an example of how the bank would lose their required share capital amount with no other influences taken into consideration.

The additional element is the fact that in the registration document, issued by the Commercial Court, the amount of founding capital in foreign currency is disclosed, stating that the shareholders are liable for the operations of the bank up to the amount of contributed share capital - in foreign currency.

Positive signs

The authorities in the Republic of Serbia are considering the changes of the Law on securities and financial markets and the Law on banks and other financial organizations.

FIC Recommends

The Law on securities and financial markets should be subject to change, allowing it to issue shares in foreign currency.

Legal Lending Limit

Current situation

According to the Law on banks and other financial institutions, one of the compliance criteria set for commercial banks is the maximum amount of placements to the single counterparty of 25% of the bank's share capital ("largest exposures"). The definition of the single counterparty includes exposures toward all individual counterparties that are considered to represent related parties. Additionally, the total amount of the largest exposures should not exceed 400% of the share capital.

In the period from 2001 to 2004, the Serbian banking sector had witnessed the significant change in the composition of the industry with over ten new banks established or purchased by foreign banking groups. This process is to be continued in 2005 with the privatization of main domestic banks. The transition in the financial sector had been followed by the privatization led change in the capital structure in the most propulsive sectors in Serbian economy as pharmaceuticals, cement, tobacco, construction and household chemical industries. Consequently, the new segment of growth oriented companies with firm support from their multinational company background had been established in the Serbian economy. Besides the entrance of the multinational companies through direct or portfolio investments, there is also the increasing group of the propulsive domestic companies that are successfully expanding their presence on the local and international markets.

Further development of operations of these groups of companies on the local market requires the support of the local banking sectors. However, this support is being limited by the legal lending limit regulations. One of the solutions used was overflow booking of the excess amounts by the headquarters of the involved local banks. However, this solution had not been beneficial for local banks in many aspects.

Additionally, the growth of the lending operations had also led to the fact that foreign capital established banks are also approaching to the limit of 400% of total placements to largest exposures.

Positive signs

In the spring of 2004, the NBS had introduced the change in calculation of the exposure amount towards a single entity.

Several deduction items had been introduced: cash collateral deposits, short-term deposits up to seven days with prime rating banks, placement guaranteed by prime rating banks.

However, regarding the last proposition, NBS had stipulated restrictions in the use of guarantees of the mother banks, as the reduction in the calculation of the legal lending limit.

In the light of the current unsatisfactory level of country rating, the possibility of obtaining mother bank guarantee for placements represents the important factor in promoting lending activity in the country. The main shareholder banks of Serbian bank subsidiaries are the banks whose rating is, in most cases, highly above the level required by NBS (Standard & Poor's, Fitch-IBCA or Thompson BankWatch - BBB; Moody's - Baa3). Exemption of this collateral option represents creating a more difficult environment for local companies, as well as impairing the willingness of main shareholder banks to support activities of their subsidiaries in the Republic of Serbia.

FIC Recommends

- *NBS should allow full deduction of receivables guaranteed by mother bank guarantee in the calculation of the legal lending limit.*

- *Placement guaranteed by prime rating banks should not exclude mother company banks if the rating would be in accordance with the stipulations of the law. Prior approval of the National Bank of Serbia should not be required.*

Serbia and Montenegro, transactions between entities and individuals

Current Situation

A significant problem arises from the fact that Serbia is treating the entities and individuals from Montenegro in the same manner as those from Serbia, whereas Montenegro takes the stand that these are entirely two separate financial and monetary systems. Given such approaches, no regular CSD and FCY payment operations or credit operations, can be possible between Serbian and Montenegrin entities and individuals. The banking systems in Serbia and Montenegro are independent and completely separate. A bank from Serbia can not establish a branch in Montenegro, and vice versa. Furthermore, a bank from Serbia may establish a business presence in Montenegro by founding a new bank (green field investment) either in the form of joint-stock company (bank) or affiliate, i.e. as a subsidiary bank with independent legal status. In both cases the founding capital (minimum pecuniary capital) is EUR 5 million for a bank in Montenegro, and or EUR 10 millions for a bank in Serbia.

Positive signs

A new law that would regulate payments and credit relations between Montenegro and Serbia is in preparation.

FIC Recommends

- *Although it was already recommended in the White Book 2004 issue, FIC urges the acceleration of the harmonization of the legal and economical framework between Serbia and Montenegro*

Syndicated Loan

Current Situation

NBS persists with the attitude that:

- this is still considered a foreign exchange loan transaction between Serbian residents irrespective of the fact that the loan administrator (Agent) is a foreign bank;
- foreign exchange loan transactions in the country as stipulated by Article 20 of the Foreign Exchange Operations Law allow financing only of import goods and services.

FIC Recommends

- *NBS should exercise a more flexible approach in the interpretation of Foreign Credit Transactions Law taking into consideration:*
  - *Solutions already included in the Foreign Exchange Law*
  - *Modern (new) forms of international loan products*
  - *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 the possibility for the local banks to be Lead Managers and Underwriters in syndicated loans granted to foreign or local borrowers.

- *The FIC would be ready to provide expertise to the government in order to assist the formation of the framework regarding syndicated loan.*

Interbank Foreign Exchange Market

Current Situation

According to the NBS Decision on the requirements and procedures in the foreign exchange market operations, an authorized bank must not participate in the Inter-bank Foreign Exchange Market (IFEM) session. This is in case it purchases or sells foreign exchange and currency in direct contact with another authorized bank, or a bank whose foreign exchange risk ratio exceeds 30%, or in case it has failed to report this ratio to the NBS. In such cases, a bank must not participate in the IFEM session for a period of one business day. NBS publishes a black list at 11 a.m. The system produces a great deal of hesitancy and uncertainty on the part of dealers who do not know in advance whether their counterpart is fulfilling NBS requirements or not.

FIC Recommends

- *NBS should use some other regular controlling mechanism to avoid the adverse impact of bureaucracy on the operation of the foreign exchange market. Banks should be able to use the same reporting mechanism as, for example, the mechanism for liquidity reporting.*

Category of commission	Debt securities				Shares	Proposal
	NBS bills	Government T bills	Government FX Bonds	Commercial papers		
1) At BSE – two options:						
Option I - BSE trading fee	-	-	0,10%	0,10%	0,10%	
Option II - Free BSE trading fee	-	-		0,05% - 0,15%	0,16%	
2) With the Central Registry – two options:						
Option I - Central Registry' fee for **OTC**	0,10% max CSD 5000	0,10% max CSD 5000	-	0,10% max CSD 5000		**To adjust to the RTGS costs**
Option II - Central Registry's fee at **BSE**	-	-	0,10% max CSD 1000	0,10% max CSD 1000	0,10% max CSD 1000	
SWIFT charges	300 CSD	300 CSD	300 CSD	300 CSD	300 CSD	
3) Taxation						
Tax on turnover (20%)	-	-	20% on total commissions	20% on total commissions	20% on total commissions	
Tax on financial transactions	-	-	-	0,22%	-	
Tax on absolute right's transfer (0,3%) – on seller's charge	0,3%	0,3%		0,3%	0,3%	
Tax on capital gain – on seller's charge	14 % on margin	14 % on margin for legal entities 20% on margin for individuals	14 % on margin for legal entities 20% on margin for individuals	14 % on margin for legal entities 20% on margin for individuals	14 % on margin for legal entities 20% on margin for individuals	**To reconsider tax policy**
Tax on interest (only for individuals)	-	20% after reducing for tax on capital gain	20% after reducing for tax on capital gain	20% after reducing for tax on capital gain	20% after reducing for tax on capital gain	
TOTAL 1+2+3	**Min 0,4%**	**Min 0,4%**	**Min 0,2%**	**Min 0,72 %**	**Min 0,56%**	

By calculating the above commissions, the following fees have to be considered in certain proportions:

Securities Commission's fees

- Fee for issuing licenses for performance of brokerage 3% of the capital (for banks - 3% of the capital which is calculated on the basis of brokerage house's capital needed for performing selected activities)
- Fees regarding adjustment of the broker's internal regulations and appointment of the director and members of management: from 10.000 CSD to 35.000 CSD
- Fees for publishing and delivering the annual report of the broker, custodian bank and other participants: 35.000 CSD
- Fees for issuing licenses to the bank to become a custodian bank 150.000 CSD
- Fees for organizing training and examination for obtaining the title of broker, investment consultant and portfolio manager: from 70.000 CSD to 200.000 CSD and other fees, whereas the minimal level is at 10.000 CSD.

Particular fees of the Central Registry:

- Membership fees: 240.000 CSD
- Opening certain categories of accounts: 10.000 CSD per account
- Installation and servicing of the client's application: 30.000 CSD

Positive signs

Positive signs are that the monetary authorities began to create positive environment for further development of the securities market. Last year the Ministry of Finance started issuing the T-bills, at first every three months, and then every six months, where the participants (both the banks and brokers) have been free enough to define the real market price of the money. The 3M T-bills discount rate is the only real price at the money market in this country. Another positive sign is that the central bank is preparing to start with the repurchase agreements, and at the same time we could see that the stock exchange is preparing for progressive electronic trading, supported by the simultaneous actions of the Central Registry, which tends to become a clearing house.

FIC Recommends

- *General tax reform, especially abolishment of taxes on absolute right's transfer, taxes on financial transactions, as well as taxes on interest after reducing gain on margin, as the current tax burden effectively prohibits secondary trading with short term investments.*

- *Reconsidering the level of the Securities Commission's fees which are too high*

- *Reconsidering the level of the Central Registry's fees, for example by adjusting them to the RTGS costs*

- *Achieving better transparency at BSE and organizing better information, specially regarding OTC trading*

Compulsory reserve on refinancing loans from abroad

Current situation

According to the Decision on the Mandatory Reserve of the Banks held with the NBS, the mandatory reserve is calculated on all deposits. Starting December 18, 2004, the mandatory reserve will pertain to the loans taken from abroad as well.

As a consequence, such a measure will increase refinancing costs and it is to expect an increase of interest rates when banks are lending money.

In a situation when access to international financial market is restricted for SCG and it is fairly difficult to collect medium and long-term deposits, such a measure does not fully correspond to the local financial needs and it will not lead to the expected drop in interest rates.
It is also wrong to make a direct correlation between consumer loans and refinancing loans, because consumer loan portfolios differ from bank to bank.

Positive signs

Hardly any positive signs can be identified right now. Measures are rather new to the banking sector and are yet to produce the results anticipated by the NBS.

FIC Recommends

- *Bearing in mind the slowdown in consumer landing as a primary intention of this measure, we propose the establishment of certain ratios, which will define a portion of consumer loans as a percentage of the total exposure of the bank, or to define the volume of consumer loans in proportion to the bank's equity.*

Loan Loss Provisions issue

Current situation

The methodology for the setting and calculation of loan loss provisions that the Bank's on and off-balance sheet has is currently regulated by the National Bank of Serbia's Decision on the classification of on and off-balance sheet items, whereby the provisions for category B, V, G or D exposures are to be booked as an expense. At the same time, the Law on accounting stipulates that the banks have to prepare and present their financial statements in accordance with IAS. Taking into account that paragraph 45 of IAS 30 (Disclosures in the Financial Statements of Banks and Similar Financial Institutions) stipulates that:

Local circumstances or legislation may require or allow a bank to set aside amounts for impairment losses on loans and advances in addition to those losses that have been recognized under IAS 39. Any such amounts set aside represent appropriations of retained earnings and not expenses in determining profit or loss. Similarly, any credits resulting from the reduction of such amounts result in an increase in retained earnings and are not included in the determination of profit or loss.

It can be concluded that certain provisions of the mentioned NBS decision are not in accordance with IAS (and consequently Law on Accounting). Consequently, no audit opinion on statutory financial statements for year 2003 had contained the statement "... in accordance with International Financial Reporting Standards", which represents the severe set-back in implementation of IFRSs/IASs. There is also an additional cost for the banks, in order to meet the requirements of their international counterparties, to prepare separate financial statements in accordance with IFRS and to have them audited.

FIC Recommends

- *Taking into account the importance of IAS compliance, especially in the banking sector, NBS should amend the article 2 item a) of its Decision on the classification of on and off balance sheet items, in order to allow the banks to properly recognize the effects of loan loss provisions in their financial statements.*

Chapter 10

Leasing

Current situation

2004 was definitely a very dynamic year for the leasing industry.

The effect of the Financial Leasing Law, which came into force in August 2003, complemented the changes in the Tax Law, and was even felt in the fourth quarter of 2003. However, the full effect of the framework provided by these laws was seen at the beginning of 2004, with a very fast increase of the leasing business, both in number of contracts and in volume.

At the time of writing, there are twelve leasing companies operating in Serbia, ten of which are international, and two local. The total amount of vehicles and equipment financed in 2004 was approximately EUR 350 million, with 30% of this figure being plant and machinery, and the rest vehicles (passenger and commercial). There were more than 15,000 contracts activated in 2004, with an average value of the contract of EUR 20,000, showing clearly that leasing is a financial tool very much accepted by the SMEs in Serbia. As far as repayments are concerned, there were no major problems. In general, 2004 was very good for leasing.

In June 2004, the official Association of Leasing Companies in Serbia (ALCS) was established with nine founding members. Its main goals are very similar to the objectives of the FIC Leasing Committee: to create a favourable framework for the leasing business, to provide a single information point for existing and potential clients, to ensure a level playing field for all leasing companies, and to join Leaseurope - the European Federation of National Associations. Together with the FIC Leasing Committee, the ALCS will contribute to the effectiveness and efficiency of relations with authorities and improving the environment for the leasing business.

The fourth quarter of 2004 saw preparations for the VAT introduction on 1 January 2005. Unfortunately, the VAT Law did not address leasing transactions at all. Only the Manual on VAT Application managed to clarify to a large extent the treatment of leasing transactions. This Manual was published on 7 December 2004, which left very little time for leasing companies to prepare for the actual introduction of VAT three weeks later. However, a relationship has been established with the Ministry of Finance whereby the issues of concern for the leasing industry were communicated, in order to clarify the remaining issues.

As regards real estate leasing, there were no changes in 2004 - this segment is likely to show development signs in 2005. Now that VAT has been introduced, the crucial missing step is for real estate to be regulated by the Financial Leasing Law. The amendment of this law is one of the top priorities on the leasing industry's agenda.

The Register of Leasing Contracts started operations on 1 January 2005. Its aim is to provide information to third parties on objects financed via financial leasing, thereby decreasing the risk of potential misuse of leased objects when dealing with third parties. The drawback introduced by the Register is that it is heavily paper-based and increases the paperwork needed for registration.

As a final note, we are witnessing a crucial reform point of the Serbian economy. At the beginning of 2005, VAT comes into force, International Accounting Standards are introduced for the legal entities and new depreciation rates are implemented - these changes are definitely going to modernize the Serbian economy and provide a base for new development. On the other hand, it can be noted that some of the advantages that made financial leasing attractive are not in place any more: VAT is charged on leasing transactions, a fee for registering leasing contracts has been introduced, and there is still no tax deduction for companies which take equipment under financial leasing. These issues are ones which the leasing industry seriously intends to resolve, in order to bring them in line with the EU standards so that leasing can maintain the place it deserves, as in all successful economies.

Positive signs

- *Fast development of leasing industry, huge market potential*
- *VAT law introduced on 1 January 2005*
- *Register of Leasing Contracts introduced on 1 January 2005*

FIC Recommends

- *Inclusion of real estate in the Financial Leasing Law, in order to enable financing of real estate via financial leasing. At present, these transactions are regulated by a number of Serbian civil laws, however financial leasing would definitely boost this business segment, and would contribute greatly to the development of the economy as a whole. The experience of other transition economies shows the very positive effect of this development.*

- *Operating leasing should be recognised and introduced by the Ministry of Finance, in accordance with International Accounting Standards, as soon as possible.*

- *A Register of Leasing Contracts should simplify the registration procedure. The necessary paperwork should be greatly reduced, and the system of using an electronic signature should be implemented as soon as possible.*

Chapter 11

Real Estate

Land Ownership

Changes vs. last White Book

During 2003, a new Law on Urban Planning and Construction was adopted by the Serbian Parliament. This Law introduced a number of changes, related to land ownership, that influenced the land market in 2004, and introduced a variety of options in terms of land acquisition. However, the general rule has remained as follows:

- Urban land remains the sole property of the Republic of Serbia
- Agricultural land remains privately owned, however, the agricultural land can be transferred into urban land through a relatively easy and inexpensive procedure if it is in included in the Master Plan

The process of land acquisition, however, has changed to allow several new possibilities:

Up to 99-year lease of urban land

This method of land acquisition refers to undeveloped urban land that is under the jurisdiction of the local Municipal Agency. In Belgrade, this is the Agency for Building Land and Development.

Transferable "rights of use"

"Rights of use" is a specific legal term referring to a type of land ownership existing before in the countries of former Yugoslavia. This was the only known way of owning urban land in Serbia until 2003, when the new Law on Urban Planning and Construction was adopted. As opposed to the long-term lease right, introduced by the new Law on Urban Planning and Construction, the "rights of use" were granted for a permanent time period, on the basis of either: (i) ownership over the building constructed on urban land, or (ii) intention to construct a building on urban land. The "rights of use" is attached to the ownership of the building located on urban land. It entitles the user to permanently use the land for as long as they own the building. The "rights of use" are irrevocable and permanently "attached" to the ownership of the building located on a particular land lot, and it is acquired, transferred and terminated automatically with acquisition, transfer or termination of ownership of the building.

Except for the above "rights of use", which are transferable along with the ownership of a building located on urban land, there is another type of "rights of use" which are transferable, whether or not there are objects located therein. This type of "rights of use" was introduced by the new Law on Building and Planning, and may exist over undeveloped urban land which is restituted to individuals from whom the land was taken (nationalized) after the Second World War. These individuals are free to dispose with the "rights of use" over undeveloped urban land once the competent Municipality renders a decision on restitution of the land.

Freehold of agricultural land that can be transferred into urban land

As mentioned above, there is privately owned agricultural land within the new Master plans that can be transferred into urban land through a relatively easy and inexpensive procedure.

These changes led to the availability of private offers for land, especially within the outskirts of the city. Although the land market is far from being favourable, the introduced changes have had some positive impact on the development of land market. The main problems, however, are still ahead.

Survey 2004

During September 2004, the Real Estate and Construction Committee of the Foreign Investment Council conducted a survey among foreign companies in Serbia, including professional consultants with real estate experience, real estate developers, investors and other companies whose business relates in some way to real estate and/or construction as well as tenants (occupants). The main goal of the survey was to gather information on the challenges that foreign investors face in the country, with the objective of developing and prioritizing reform initiatives that can lead to a better investment climate in the country.

With regard to the process of urban land acquisition, only 13% of the respondents think that the availability and amount of urban land offered are adequate. Furthermore, only 7% of the respondents think the price of urban land has a fair value.

Out of all respondents, only 14% thinks that the Governmental agency in Belgrade dealing with land acquisition has been responsive and cooperative. And again, a striking 0% of the respondents find that the process of acquiring land through public tenders and auctions lacks transparency. Then again, 0% of the respondents think that there is sufficient information on past transactions and prices achieved during these public tenders and auctions.

The same is the situation regarding access to information about available sites for development. Only 6% think that such information is available to a large degree and all of them (100%) find the process of acquiring information on available sites time consuming and costly.

Furthermore, 94% think that the process of acquiring information about available sites for development is non-transparent and 88% think that there are too many middle-men involved to a larger or lesser degree.

In terms of the methodology used to calculate land prices, 0% think that prices reflect market value. Additionally, all respondents think the methodology of land price calculation is inadequate and prohibits development of the whole sector.

These are just a few of the results of the Survey, which have been nothing less than overwhelming. They consistently show dissatisfaction with the inefficient and bureaucratic procedures, the lack of transparency within the activities of the relevant government authorities dealing with land acquisition, and misuse of power.

Remaining problems

Unfortunately, the main problems related to land ownership, which are impediments to foreign investment, remained unchanged:

- Lack of possibility for freehold ownership of land within the central city areas, where the majority of land remains in the ownership of the Government, even if the " rights of use" are transferable
- Prevailing governmental control over the supply of larger pieces of land within the central city areas which results in:
- a process of land acquisition that lacks transparency and is long and bureaucratic
- an insufficient supply of land
- no information on past transactions and prices achieved

- Minimum prices of the majority of urban land remain determined with governmental ordinances, instead of the market
- The Law on Urban Planning and Construction was not fully enforced with regard to undeveloped land

FIC Recommends

- *Changing the Constitution of Serbia to allow freehold ownership of land; introduction and completion of the process of Restitution, and completion of the land registry system.*

- *Development of a publicly available database with all urban land available for construction following the adopted Master Plan, as well as including complete information on past transactions.*

- *The introduction of a system that allows for forming of prices, based on the free interaction of supply and demand.*

- *Enforcement of the Law on Urban Planning and Construction with regard to undeveloped land, and land that has not been developed until specified by the law deadlines. Execute this in a transparent manner and under a tight schedule.*

Construction

Changes vs. last White Book

During 2003, a new Law on Urban Planning and Construction was adopted by the Serbian Parliament, which introduced a number of changes aimed at reducing the time for acquiring permits. However, the expected objectives were not met.

Survey Results in the Field of Construction

According to all respondents of the Survey (referred to here above), the procedure of acquiring construction and other related permits from the relevant governmental bodies is too long and bureaucratic to a larger or lesser degree. Furthermore, 86% think that governmental bodies misuse their discretionary rights to a larger or lesser degree.

Regarding the planning procedure and obtaining of urban permits for general design, everybody considers the process too long and bureaucratic to a larger or lesser extent, and 92% think that the governmental bodies misuse their discretionary rights to some extent.

Remaining Problems

- The Law on Urban Planning and Construction was not properly introduced and it did not lead to the speeding up of the procedures.
- The construction industry (construction companies) remain predominantly state-owned
- The processes of acquiring construction permits remain corrupt, long and bureaucratic

FIC Recommends

- *Training relevant institutions to allow for the proper enforcement of The Law on Urban Planning and Construction*

- *Privatization of the construction industry*

- *Development of an "office-expediter" or "one-stop" office within the Government, whose role is to assist large real estate developers with projects in excess of EUR 5,000,000 million, as a way of having "success stories".*

Municipal Real Estate

Remaining Problems

A large number of real estate properties on prime locations in Belgrade and the rest of the cities of Serbia remain in municipal ownership. Those of them with attractive locations, especially on the prime retail streets of Belgrade are being rented by the municipality at rents that are several times lower than the market rents, while their legal occupants enter into semi-legal or pro-forma agreements with third parties for several times higher rents. These processes contribute largely to the grey economy and reduce income to the budget while at the same time they defer quality retailers from entering the market.

FIC Recommends

- *Organisation of a transparent process of asset disposal for all municipally owned properties.*

Restitution

Remaining Problems

In the last White Book, we emphasized that the lack of clarity on the issue of restitution continues to create uncertainty and deters many real estate investors from investment in Old Belgrade.

In October 2004, the Serbian Government brought a decision to appoint a Commission for preparation of the Law on Retrieving of Taken Away Property and on Restitution. The task of the Commission was to prepare the Law by the end of October 2004. However, in November, it was announced that the Law on Restitution would come before Parliament by the end of the year or by March 2005 at the latest.

FIC Recommends

- *Introduction of the Law without further delays from the last announced dates.*

Chapter 12

Insurance, Pensions and Social Reform

Insurance

The continuing instability of the insurance sector in Serbia has been attributed to a wide range of microeconomic and institutional failings. While having over 40 companies registered for insurance businesses, approximately 70% of the annual premium is concentrated in two state owned companies. Lax management, weak corporate governance and frail supervision have been the main obstacles for the development of this sector. In the continued absence of market discipline, the entire burden of external control falls on insurance supervisors who may not have the requisite capacity.

While much has been done this year to start stabilizing this sector, there is no real growth and development. The market is still very concentrated with very limited competition, this reflects to the products offered as well as to the slow entry of foreign players. The legislative work in process is once again aimed at the stabilization and not at the development and privatization required.

Positive signs

A new Insurance Law was adopted in May 2004, introducing new requirements gradually to be fully implemented by 1 January 2006. Insurance supervision has been transferred to the National Bank of Serbia which has undergone massive changes and strengthening with the aid and support of USAID. The new supervisory authority already employs 30 people with the prospect of doubling in 2005. It has taken strong action to stabilize the market to include on site supervision of all registered insurance companies and has recently revoked 11 insurance licenses We welcome the introduction of new discipline in the sector.

FIC Recommends

- *The collection of claims data by cooperation with insurers is encouraged.*

- *The insurance supervisory authorities should establish a reliable claims database that will assist insurers and supervisors in developing the right price for various categories of products.*

- *The insurance supervisory authority should:*
  - *apply prudent regulations and conduct consolidated supervision,*
  - *obtain and independently verify relevant information,*
  - *engage in remedial action and execute portfolio transfer,*
  - *apply sanctions against insurance companies which do not follow the recommendations and injunctions of the supervisory authorities*
  - *have broad and ample knowledge and experience ranging from actuarial science to contract law drawn from wide experience;*

- *have a reliable and stable source of funding to safeguard its independence and effectiveness;*
- *have the powers and sufficient resources to co-operate and exchange information with other authorities, both at home and abroad, thereby supporting consolidated supervision;*
- *establish an employment system to recruit, train and maintain a professionally qualified staff. At the same time, the insurance supervisory authority must be bound by strict professional secrecy and the legislation must exclude any arbitrary intervention of the administration.*

- *Except in cases stipulated in the law, the insurance supervisor should under no circumstances be allowed to interfere in the management of insurance companies.*

- *The supervisory authority should establish good cooperation and undertake coordinated 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.*

- *Subject to prudential regulations and supervision being met, competition in the insurance sector should be fostered by removing unnecessary restrictions and allowing participation of sound insurance companies in the insurance market. In particular, establishment of foreign insurance companies should be based on prudential but non-discriminatory rules.*

- *Ensure 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.*

Pension and social reform

The pension system is facing challenges in terms of its sustainability. The situation in the pension system is influenced by exogenous factors linked with changes in the structure of the population, the low level of employment and the presence of the grey economy in the area of employment. Longevity and the low birth rate, for simple replacement of generations, have conditioned the aging of the population. These trends continue to dominate this sector in 2004.

Although positive signs are evident, there is a lack of a long term strategy to tackle the issue of pensions on the state and the private funded level. The voluntary pension system lacks adequate legislation and tax incentives to facilitate potential growth.

Positive signs

The Government has continued parametric reforms aimed at tightening the deficit in the public pension system mainly through broadening the contribution base and clamping down on pension payments.

The Government has been debating the issue of pension reform and a new law on Private Voluntary Pension funds is being prepared.

FIC Recommends

- *Provision of stable rules that encourage the voluntary creation and maintenance of soundly financed employer-sponsored plans;*

- *Introduction of an efficient means for individuals to acquire adequate retirement income;*

- *Support the dynamic needs of employers;*

- *Introduction of the Government's commitment to voluntary employment-based retirement programs;*

- *Encouragement of capital formation.*

- *Education of the Serbian worker, so that they have the necessary skills to equip them for retirement.*

- *Provision of more opportunities to use modern technology for disseminating information to employees about their plans and in providing employee education.*

- *Encouragement of redundancy programs with a pension saving plan over cash benefits.*

Chapter 13

Telecommunication Sector

General overview of the sector

Mobile telecommunications are growing very fast and the number of subscribers is still increasing quickly in a very competitive market. There are some three million mobile subscribers in Serbia and the penetration rate has reached 40%. Fixed-lines have registered a much slower growth. The number of Internet users in Serbia is estimated at 650.000 but the number of Internet subscribers is far below. Internet penetration is very low (6.5%).

Market players

Telekom Serbia was given a 20-year licence to operate fixed-line telecommunications with the first eight as a monopoly (until 9 June 2005). The company was also granted a 20-year mobile licence, making it the second mobile operator in Serbia. Telekom Serbia is the only fixed line operator in Serbia with 2.4 million subscribers, out of which 520 000 are shared lines and 950 000 subscribers connected to analog stations. The digitalization rate of the fixed line network in Serbia is still rather low (60%) compared to a majority of European countries (100%). There are two licensed mobile operators in Serbia: Mobtel (063) and Telekom Serbia (064).

Legal Framework

The new Telecommunications Law in Serbia was adopted in April 2003. Prior to this, the Law on Systems of Communications was in force and regulated both areas: telecommunications and postal services. This law is still valid in some of provisions dealing with postal services and its public provider. The Law anticipates the creation of a liberalised telecommunication market with a system harmonized with that of Europe. Fixed-line is an exception, with the state respecting the 1997 contract for the sale of shares in Telecom Serbia to OTE of Greece and Telecom Italia, which guaranteed monopoly status until 9 June 2005.

Regulatory Authority

The Serbian regulators are the Ministry for Capital Investments (the former Ministry of Transport and Telecommunications), and upon the adoption of the new Law on Telecommunications the Serbian Telecommunication Agency, which is still not established.

Remaining issues

Unfortunately, the main issues in the telecom sector in Serbia are still left unsolved:

Adoption of the Amendments and Revision of the Law on Telecommunications

The new Law on Telecommunications was in a preparatory phase for more than two years, but was finally adopted in April 2003. The main goal of the new Law is to provide legal framework for fundamental reforms in this area. The Law introduced principles for granting licenses for telecommunication activities, and for the first time introduced the universal service obligation ("services of specified quality and scope which are available to all users of the public telecommunication network in Serbia, at reasonable prices"). The objectives of the new Law is to start the process of elimination of monopolies and monopolistic behaviour, regulate and control the telecommunication service tariffs under the conditions of a limited market, and to increase the quality of services and introduce new services to this market. In the course of 2004, the new Law on Telecommunications was a subject of further review and amendments mostly with the aim of further improvements in the area of efficient implementation mechanism. The remaining issue is when the amendments proposed will be adopted in the Serbian Parliament.

Lack of key regulator

The law defines the independent regulatory body, i.e. the Telecommunication Agency (TA) that undertakes the role of managing the telecom sector. It is prescribed by the Law that the TA should be separated from both: the influence of the State, as well as the impact of interest groups, mainly telecommunications operators. However, since the TA is still not established, the practical implementation of the new Law on Telecommunications is impossible. The TA will be managed by the Managing Board, consisting of five members proposed by the Government and appointed by the National Assembly. The National Assembly has tried to appoint members of the TA but due to the political situation it is not certain when this body can take effect. The latest expectations of the Ministry for Capital Investments indicate that the TA may be fully operational in the early 2005.

Adoption of the Telecommunication Policy Document and the Strategy for Development of Telecommunications in Serbia

The Ministry for Capital Investments commenced development of the Telecommunication Policy Document, expected to be completed by the end of January 2005. Also, in 2004 the Strategy for Development of Telecommunications in Serbia was completed. However, the Strategy requires further revision in order to be fully aligned with the Policy Document. Therefore, it is uncertain when the final adoption of this important document will take place.

State cross-ownership

The Serbian telecom sector continues to be dominated by the State, which represents a significant obstacle to competition. Serbian authorities indicated possibilities for launching the privatization of major telecoms in 2005, but legal issues make their fast privatization unlikely. Despite much criticism, the state owned Company PTT is owner of both mobile operators: the majority owner in Telekom Serbia and a minority owner in Mobtel. The settlement over the ownership structure in Mobtel that represents the major obstacle in solving the issue of state cross ownership has not yet been resolved. Despite frequent announcements that the tender for privatization of Mobtel will be launched soon, it is still not clear when it will happen and whether it will be postponed until the final decision of the arbitration in Switzerland.

Process of deregulation and full liberalization of the Serbian telecom sector

The licenses granted for fixed and mobile telephony in Serbia have created long-term monopolies, with no obligations regarding future development or improvement to the quality of service. This creates an obstacle to future market liberalization. Based on the law, the liberalization process of the fixed telephone line market is scheduled to happen in 2005. The restructuring of state-owned companies, including spin-offs of the non-core businesses, and the sale of non-core assets, remains to be one of the key priorities for the Government next year. The entry of the foreign players will boost competition and secure substantial funds for technological upgrade of the telecom infrastructure.

However, if the Telecommunication Agency is not formed by the time the liberalization takes place, the telecommunication sector in Serbia will enter the vacuum, where the monopoly of Telekom Serbia will be just as strong as today, due to the absence of rules and regulations for other market players. Therefore, the formation of the Telecommunication Agency is absolutely necessary for further development of the telecommunication sector in Serbia after the deregulation.

FIC Recommends

General recommendations relate to completion of the above mentioned tasks without further delays from the previously announced deadlines.

- *Immediate adoption of the amendments and revision of the Law on Telecommunications;*
- *The Telecommunication Agency must be finally formed and fully operational;*
- *Speedy adoption of the Telecommunication Policy Document and the Strategy for Development of Telecommunications in Serbia;*
- *Further liberalisation of the fixed line market and the data transmission sector;*
- *Further liberalisation of the mobile line market.*

Chapter 14

Environment

Compared to the last year, there are few changes in the area of environment protection:

- The Ministry for Protection of Natural Resources and Environment (established in May 2002) no longer exists as such. It had been merged with the Ministry of Science into the Ministry of Science and Environment Protection, under which Directorate for the Environmental Protection has jurisdiction over environmental issues.
- In December 2004, the National Assembly adopted a set of environmental laws: Law on environment protection, Law on Environmental Impact Assessment, Law on Strategic Environmental Impact Assessment, Law on Integrated Prevention and Pollution Control.

It is still early to say how these changes will influence the current situation: low enforcement of existing regulations (developed under the previous set of environmental legislation) and standards, fragmented institutional competences, inconsistent legal and organizational frameworks with limited mandates and insufficient staffing, weak monitoring system, allocation of available funds from the general budget resulted with low environmental efficiency.

Addressing environmental considerations in the privatization process reduces investment risks and uncertainties about potential costs in the future. Foreign investors are concerned about possible unfair treatment regarding liability for inherited damages and about unexpected environmental requirements on the local level. Economic instruments that are in place are mostly directed to generate revenue, instead of being related to environmental performance.

In 2004, some foreign investors were faced with arbitrary and discriminatory practices by municipal governments, which are entitled by the Law on Local Self-government and the Law on Environmental Protection to charge legal entities on their territory a tax or fee for environmental protection costs. Municipal governments use their authority to charge those legal entities substantial fees. This unfair and arbitrary behavior directly results in increasing the company costs and represents a risk to investors. Also, there is no clear criterion for evaluation of the level of the compensation and therefore investors are faced with legal insecurity. On the other hand, the significant difference in charging polluters from the same branch of industry, results in those who are heavily charged in unequal position on the market. Unfortunately, the new draft Law on Environmental Protection entitles the municipality to decide on the amount of compensation for environmental protection and the method of payment, thus ensuring that this behavior can continue.

For most of the foreign investment industries, compliance with local legislation is a minimum requirement for environmental performance, having even more strict internal standards. At the same time, many industries in Serbia operate without compliance with environmental standards providing a generally known explanation: the difficult economic situation. Even though inspections are carried out, there is a low "risk" of being caught. Just a few of inspections result in administrative or legal charges, fine levels are too low, and court procedures are too long. Considered through various fees and charges required for full compliance with local legislation, it is easy to come to the conclusion of unfair business environment in Serbia.

Environmental Impact Assessment (EIA)

New Law on Environmental Impact Assessment clearly defines all elements for the EIA, and it is, to the great extent, similar to the European practice. On the other hand, environmental authorities do

not have sufficient capacity to screen projects, properly review and approve submitted EIAs. It is very common that local authorities issue permits neglecting the incomplete or even missing environmental impact assessments.

According to the Law on Planning and Construction, the EIA is the precondition for draft project notarization and obtaining the construction approval. After this approval is obtained, legal entity can proceed with preparation of technical documentation for the main project. The main project also has to be notarized, which is, once again, a time consuming process. According to the new Law on EIA, some information needed for EIA can only be obtained from the main project (not from the draft project). This all brings additional confusion to the whole process of obtaining construction permit, resulting in the additional slowing down of the construction of new production facilities.

Process clarification, better cooperation between relevant Ministries, government institutions and potential investors could be the way to overcome above-mentioned issues and competence overlapping.

Waste management

Absence of proper waste management practices, lack of sanitary landfills, exposure to the significant health risk due to inadequate disposal of hazardous, medical, chemical and animal waste, no systematic solution for waste recycling etc. The list of waste management problems is too long for this paragraph.

The Government objective is to obtain compliance with EU legislation. Current practice in waste management is pointing out that, with the existing institutional and legislative set-up, it will be hard to reach the objective. Rationale for this observation is experience with the Regulation on conditions and manners of classification, packaging and storage of secondary raw materials - inert waste (Official Gazette of the RS No.55/2001). Basic for this Regulation was European Waste Catalogue, which is optional for the Member States. Yet, the local Regulation is mandatory for all waste generators.

According to the Regulation, City Health Protection Institute Belgrade is the only institution nominated for issuing the waste character document (based on sampling and analysis conducted only by this institution), while the Republic Agency for Recycling is the only institution in charge for issuing waste category document. Both documents are required by the Regulation 55/2001, and are issued for the limited period of time and defined waste quantity. Considering the number of waste generators in Serbia and available capacities in the mentioned institutions, it is not surprising that procedure for compliance with this Regulation is rather long. There is an obvious need for additional institutional strengthening and capacity building in Serbia.

Positive signs

- *Adoption of the new Law on environment protection, and other laws in this field*

FIC Recommends

- *Further compliance with EU environmental regulation*

- *Amendments on the Law on Local Self-government and the Law on Environmental Protection to adopt clear criteria for issuing the local compensation for environmental protection in order to avoid legal insecurity*

- *To redefine public and private cooperation on environmental protection issues, in a way to support establishment of a fair business environment*
- *Development and implementation of economic instruments which provides incentive for environmentally responsible behavior*

- *Continuation of institutional strengthening and capacity building, in order to avoid monopolization*

Chapter 15

Transportation

A. The Law on Postal Services

Current situation:

The Law on Postal services has been waiting in the National Parliament pipeline for adoption for well over a year. It is due to be discussed and adopted by the National Parliament during the month of January 2005. There are several reasons for such a sequence of events, the Ministry in charge was reshuffled, adoption of laws with higher priorities, etc.

DHL has prepared and submitted a series of Amendments to be presented by a Member of Parliament during the adoption procedure, when it occurs.

Issues

The new Law on Postal services proposes that DHL and other express courier companies pay a License (up to an amount of 0.5% of operator's annual turnover) for the provision of their activities. This is a direct non-compliance with EU Directive. The EU Directive proposes Express Courier companies pay a Registration fee, not a License, since their activities are Value added services and not within the scope of the Universal Postal service. As per the European jurisprudence and EU Directive the Universal postal service provider (the national Postal operator) is the only one to be granted a long life, exclusive License.

By the new Law on Postal services, DHL and other express courier companies are recognized as Postal operators but not as providers of Value added services, which is again contrary to European standards.

Positive signs

Unfortunately, none of the comments have been taken into consideration. In April 2004, a meeting was attended with the new Deputy Minister of the Republic of Serbia for Transport & Telecommunications and his Deputy for Postal Traffic. This was the Ministry's initiative to get a few main operators of future plans relating to the new Law on Postal Services to be adopted. At the meeting, it was agreed that DHL submit their views on The Law on postal services and actively participate in the process of the Law's adoption.

In May 2004, amendments were submitted to the latest officially available version of the Law on Postal services to the Ministry for Capital investments, Postal traffic department. No reply was ever received.

During the same period, a letter was submitted to the Ministry of International Economic relations with a break down of non-compliances of the Draft Law on Postal services with European

jurisprudence asking for assistance during the process of the Law adoption. No reply or support was ever received.

FIC Recommends

- *Clearer distinction between Universal and Non-Universal Postal services / Providers, to be implemented by taking into account the Amendments that were previously submitted.*

- *Clear licensing and registration procedures for operators of Value Added services, to be implemented by taking into account the Amendments that were previously submitted.*

B. Automotive Sector

Current situation

Concerning vehicles, Serbia requires a special homologation and does not automatically recognize EU homologation. On the other hand, homologation can be obtained for vehicles which do not comply to EU homologation. This allows vehicles not suited to European conditions (average driving speed, different lubricants, ..), especially from the NAFTA markets, to enter into Serbia. Customers who are not aware of the differences might have problems with their vehicles, which will last less than those homologated for the European market.

No vehicle registration data is available for private companies. Registration data is usually given to companies to plan distribution networks, eg. for gas stations, vehicle dealerships, repair workshops etc. Registration data is also needed in case of technical recalls on certain vehicles.

Positive signs

Concerning vehicle homologation, some authorities expressed an interest in EU homologation standards and participated in meetings about this subject.

FIC Recommends

- *Concerning vehicles, Serbia should apply the European homologation rules. Only vehicles homologated for Europe should become homologated in Serbia.*

- *Vehicle registration data should be handed over to an association who supervises the correct use of the data, but would also generate the statistics and distribute them to the interested parties.*

Chapter 16

Media Sector

Tobacco Advertising

Current situation

Since tobacco products advertising is currently regulated by the Food Safety Law adopted almost twenty years ago, the Serbian Government's initiative to pass a new Advertising Law was supported by the tobacco industry. Under the current law, implementation and control mechanisms are not clearly defined and the penalties are very low, making the Law inadequate for a contemporary business environment.

The Draft Law proposed by the Ministry of Trade, Tourism and Services of the Republic of Serbia three years ago, was acceptable and considered a real progressive law regulating this sensitive area - tobacco products advertising. The Draft that was being discussed publicly for two years fully supported International Marketing Standards (IMS), a document signed by the three biggest tobacco companies: Philip Morris International, British American Tobacco and Japan Tobacco International.

At the end of last year, the Government of the Republic of Serbia proposed a new amended draft Advertising Law basically prohibiting all marketing freedom elements to the tobacco industry and its products. Basic tobacco industry freedom to communicate with adult consumers was violated, as the marketing standards (IMS) observed by all responsible tobacco companies entails communication which does not target a broader audience. This proposal was not included in the public debate agenda and was submitted for immediate adoption.

This form of communication foresees advertising at the sale points and direct and electronic communication, known as "one on one".

In addition to the above mentioned forms of advertising, the tobacco industry used corporative advertising by sponsoring various activities, also according to the marketing standards. In other words, the tobacco industry does not provide sponsorship for sports activities or any activity that involves underage persons.

The New Advertising Law introduces advertising restrictions at sale points and practically prohibits any promotion (new products, prices, etc) of tobacco products. The only possible communication with adults is limited to communication by packs of cigarettes or printed material adhered onto the packs. This means that it is impossible to inform the consumers about new products and their quality.

An additional restriction prescribed by the new law concerns direct communication, which is allowed but on condition of obtaining the recipient's approval. It remains unclear, how is one supposed to get approval from an advertising message recipient, if one does not have access to him/her. There is also the question of how the advertiser can prove that he/she has obtained approval from the recipient unless it is in a written form. The above mentioned shows that direct communication is impossible.

Although sponsorship is not prohibited in principle, the activities that must not be sponsored by the tobacco companies are strictly determined by the law, being: media, sportsmen, sports clubs, sport competitions, cultural and other events, professional meetings, competitions, including sponsorship for individuals, i.e. participants in such events. The ensuing question is what activity is not prohibited. Such an attitude reduces sponsorship practically to a donation and deprives many associations, talented individuals, local communities, professional magazines, etc. of a considerable amount of money.

Finally, one must say that the Serbian Government's initiative, which disables and hinders the work of new investors and creates to a large extent an unfavorable environment for all future investors, is surprising.

Alcohol Advertising

Current situation

The spirits industry in Serbia is currently subject to a very hard transition period. In general, both the local spirit production and import of spirits record a fall. Over the period of nine months in 2004, sales of locally produced spirits dropped by 11%. There are no official records for imported spirits, although judging by requests for tax strips, a drop in sales is recorded there as well. The main reasons for this decrease are the economic crisis and poor purchase potential of the population.

A good deal of social companies in this field have not yet been privatised, or are still in the process of privatisation, which also affects the offer of spirits in the market. We feel that, at this stage, it is important that the privatisation process is undisturbed and completed, this being in the interest of the companies themselves, the employees and the state. However, the latest Draft of the Law on advertising is extremely restrictive, especially concerning spirits, and definitely does not offer any support in this respect.

Three years ago, the Draft of the Law was composed by a team of experts in various fields. It was subject to public discussion, and has been harmonized with international marketing standards. Concerning spirits, it has been in accordance with the Amsterdam group, which clearly defines the socially acceptable consumption of spirits, as well as its advertising.

The Draft of the Law that came into public view in December 2004 without any public discussion, totally denies the results of the previous Draft, appearing to be extremely restrictive in the field of spirits advertising, even more than in some EC countries.

By analysing European Laws and Strategies one can see that there is no such total restriction as our Draft foresees. This normally brings us to the question of how the consumers will be informed of the products, especially new ones. By an absolute ban of advertising in media, disloyal competition will be encouraged as well as sales of doubtful products, which has already been recorded due to the poor purchase potential of population.

Claims that the advertising of spirits increases consumption is not true. Numerous analyses made in Europe in the past ten years point out that regardless how big advertising budgets are, consumption remains the same as through advertising, consumers get attached to the brand only.

Beer advertising creates discrimination among manufacturers and importers, especially in the wine industry. We must not deny that beer is also a spirit and therefore should be treated equally. For this reason, the previous Draft was more fair. We therefore support the option of advertising in media by respecting certain rules (advertising in the late hours on TV, not showing actual consumption etc.).

Further on, strict limitations of sponsorship and its advertising, without the right to show a trademark or any other sign of the brand, manufacturer or importer, will substantially affect the scope of sponsorship. Bearing in mind that sponsorship i a modern form of patronage, many cultural and humanitarian projects will be left without enough funds, which will in a way influence our quality of life. The point is that every participant of sponsorship fulfils certain goals: for the sponsorship recipient, it provides funds without which the project could not be realised, and for the sponsor it is the promotion of the company/person, their products and services.

Not to mention that by adopting such a Draft, the income of media and advertising agencies would drastically reduce while making a bad impression on potential investors in this field. You will agree that this is not favourable to anyone, especially in this period when the privatisation process has not been completed yet.

Finally, we wish to point out that our interest is that such a Law is passed that will bring order and legal safety in the field of advertising, but which will at the same time define our rights and obligations and enable us, by clear regulations, to introduce our products, with arising social awareness of moderate consumption of spirits, wines and beer.

Chapter 17

Energy Sector

Current situation

Foreign investors started entering the Serbian oil market in mid 2001. They have made a significant addition to FDI, created numerous jobs and generated additional tax revenue. They have also brought a high level of know-how and European retail culture, setting the standard for the market.

Nevertheless, many aspects of the oil market remain unchanged, despite the difficulties which this sector faces:

Inadequate Supply

The Serbian fuel market is not liberalized. Domestic refineries (Pancevo and Novi Sad) often cannot meet local demand for fuel, and consequently fuel stations run dry.

Late in 2004, the government recognised this problem and temporarily allowed fuel imports. However, due to the artificial fuel price system, none of the retailers resorted to importation as the total purchase price (including transport and customs) would have been higher than that set by the state.

Margin problem

The state sets the maximum retail prices. Furthermore, the state petrol company, Nis Jugopetrol, is the main - and very often only - fuel supplier in Serbia. This means the state effectively defines the retail margin, since it sets both the wholesale and retail prices. Historically, these margins are low, and discernibly lower than in neighbouring countries.

This problem could be alleviated though higher volumes, but this presupposes the continuous availability of fuel. Ultimately, this has a negative impact on the profitability of fuel stations.

Delays in Approvals

The necessary authorisations for the construction and operation of fuel stations are granted by different bodies often in a protracted manner. Consequently, the period from securing a site for a fuel station until operation is unnecessarily long.

Little Co-operation in the Market

There is very limited cooperation and collaboration between competitors. Alliances within the industry would help take action on matters of common interest and exchanging know-how.

Other difficulties faced by the industry include real estate ownership issues and contradictory regulations of different Ministries.

FIC Recommends

- *Reconstruction/upgrading of the two refineries, and better conditions for companies importing crude oil, within the framework of the approved quotas and through deregulation of the market, could solve the issue of inadequate supply.*

- *Modification of the pricing policy through decrease of excise rates or price liberalization to combat the margin problem.*

- *The industry recognizes that fuel prices have a major impact on the budget. It would help, however, to have more frequent corrections of retail fuel prices reflecting changes in the world crude oil price. It would also help if the pricing system allowed all market players a reasonable margin not influenced by inflation.*

- *Establishment of an Agency to oversee the process of granting different permissions, to counter delays in approvals.*

- *Formation of alliances on strategic issues of common interest to improve co-operation in the market.*

- *Privatization of the two refineries and opening the oil derivates market will ease the supply and margin problems. Retailers will see major improvements in their business which will benefit the whole economy.*

Chapter 18

Mining

Basic Features of a Modern Mining Law

A suitable legislative and regulatory framework is one of the most important factors in attracting foreign investment and expertise. An essential part of such a legislative and regulatory framework in Serbia should be a new **Law on Mining**.

Serbia's new Law on Mining must be a coherent and enduring statement of the legal regime which Serbia has established for the type of long-term international mining investor. By providing clear legislation, together with effective and efficient administrative authorities to deal with mineral affairs, the Government can eliminate unnecessary legislative risk.

This paper sets out the major provisions that investors seek in a Law on Mining and other regulations relevant to mineral operation. The provisions listed in this paper will remove much of the legislative risk that investors seek to avoid and so will provide the foundation for investment.

The investing community in Serbia believes that there is much to do to provide adequate mining legislation and other regulations relevant to mineral operations in Serbia. In addition, the investing community is calling the Government to be active on improving the quality and transparency of the administration. From an investor's perspective, the challenge for Serbia in the coming years will be not only to have modern legislation, incorporating the terms and conditions described in this paper, but also an administration that ensures the intent of the legislation is delivered.

FIC Recommends

- *Security of tenure, and a clearly linked and guaranteed transition from exploration to mining, is absolutely essential to an investor.*

- *Exploration Licences should be granted to the first applicant.*

- *A licence holder should be allowed to transfer freely all or part of its rights to one or more other parties.*

- *The Law should be transparent in its application, with minimal, if any, use of ministerial or administrative discretion, guidance, custom, or restriction.*

- *The explorer should be permitted to obtain rights to large areas of land but only for a limited period and subject to universally applied minimum annual expenditure requirements per unit area.*

- *The law should, under most circumstances, allow the licence holder the right of access to the licence area, in the recognition that mineral exploration is only a transient form of land-use, and that it can successfully co-exist with many other uses of the same land.*

- *Exploration licences should be issued for an initial period of at least two years with two guaranteed renewals available of two or three years each, the latter accompanied by the surrender of, say, 25% of the total area on each renewal.*

- *The Law should require licence holders to submit regular reports of exploration data. The Law will also stipulate that data, other than that reported by an existing minerals rights holder, will be held on open file for all parties to inspect and copy.*

- *The Law should allow the exploration licence holder to extend the period of the licence for a reasonable period if this is necessary to complete a full feasibility study.*

- *The Law should allow the normal licence period to be extended and minimum expenditure requirements to be waived on areas where the explorer has already expended substantial sums of money identifying a mineral deposit, but where current economic, technical or political factors make immediate progression to exploitation uneconomic, or otherwise unacceptable for the licence holder.*

- *A mining licence should be granted for at least 30 years, renewable for as many further 10 year periods as are necessary until the resource has been economically exhausted.*

- *Royalties, or any other output based tax, is a strong disincentive to exploration and mining by international investors. If they are levied, they should not be based on a charge per unit of volume or weight or as a percentage of revenue.*

- *Where royalties exist, the rates should be known in advance of exploration work commencing, and not be withheld until the point of the investment decision for a mine development. It is of great importance that rates are not increased after a program has begun.*

- *Other relevant legislation should not inhibit the application of the Mining Law. The Law should make clear and specific reference to other applicable laws and supporting regulations; however it is always advantageous that, if possible, investors should only need to refer to one Act and its supporting regulations, and to have to deal with only one Ministry. Where this is not possible, the authorities can greatly help investors by publishing clear guidelines to other relevant legislation.*

- *A modern mining Law will include a provision against state expropriation or nationalization of any or all of an investor's assets. The Law will also include a provision for fair and reasonable compensation to the investor under those extreme and exceptional circumstances in which expropriation or nationalization might still occur.*

Contributors to the White Book 2005:

- Allied Domecq
- Bedminster Capital Management LLC
- Bojovic & Dasic
- British American Tobacco
- CA IB
- Colliers International
- DaimlerChrysler
- DHL
- Deloitte
- DUNAV - TBI
- EFG Eurobank
- Ernst &Young
- EU Delegation
- HVB Bank
- Hypo Alpe Adria Bank - Consultants
- Karanovic & Nikolic
- KPMG
- OMV
- PWC
- Raiffeisen Leasing
- Rio Tinto
- Societe Generale
- Tetra Pak
- Volksbank

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Members of FIC

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