



The wiiw Balkan Observatory

Working Papers | 034 | November
2003

Milko Štimac

Barons Uprising





The wiiw Balkan Observatory

www.balkan-observatory.net

About

Shortly after the end of the Kosovo war, the last of the Yugoslav dissolution wars, the Balkan Reconstruction Observatory was set up jointly by the Hellenic Observatory, the Centre for the Study of Global Governance, both institutes at the London School of Economics (LSE), and the Vienna Institute for International Economic Studies (wiiw). A brainstorming meeting on Reconstruction and Regional Co-operation in the Balkans was held in Vouliagmeni on 8-10 July 1999, covering the issues of security, democratisation, economic reconstruction and the role of civil society. It was attended by academics and policy makers from all the countries in the region, from a number of EU countries, from the European Commission, the USA and Russia. Based on ideas and discussions generated at this meeting, a policy paper on Balkan Reconstruction and European Integration was the product of a collaborative effort by the two LSE institutes and the wiiw. The paper was presented at a follow-up meeting on Reconstruction and Integration in Southeast Europe in Vienna on 12-13 November 1999, which focused on the economic aspects of the process of reconstruction in the Balkans. It is this policy paper that became the very first Working Paper of the wiiw Balkan Observatory Working Papers series. The Working Papers are published online at www.balkan-observatory.net, the internet portal of the wiiw Balkan Observatory. It is a portal for research and communication in relation to economic developments in Southeast Europe maintained by the wiiw since 1999. Since 2000 it also serves as a forum for the Global Development Network Southeast Europe (GDN-SEE) project, which is based on an initiative by The World Bank with financial support from the Austrian Ministry of Finance and the Oesterreichische Nationalbank. The purpose of the GDN-SEE project is the creation of research networks throughout Southeast Europe in order to enhance the economic research capacity in Southeast Europe, to build new research capacities by mobilising young researchers, to promote knowledge transfer into the region, to facilitate networking between researchers within the region, and to assist in securing knowledge transfer from researchers to policy makers. The wiiw Balkan Observatory Working Papers series is one way to achieve these objectives.



The wiiw Balkan Observatory

Global Development Network Southeast Europe

This study has been developed in the framework of research networks initiated and monitored by wiiw under the premises of the GDN–SEE partnership.

The Global Development Network, initiated by The World Bank, is a global network of research and policy institutes working together to address the problems of national and regional development. It promotes the generation of local knowledge in developing and transition countries and aims at building research capacities in the different regions.

The Vienna Institute for International Economic Studies is a GDN Partner Institute and acts as a hub for Southeast Europe. The GDN–wiiw partnership aims to support the enhancement of economic research capacity in Southeast Europe, to promote knowledge transfer to SEE, to facilitate networking among researchers within SEE and to assist in securing knowledge transfer from researchers to policy makers.

The GDN–SEE programme is financed by the Global Development Network, the Austrian Ministry of Finance and the Jubiläumsfonds der Oesterreichischen Nationalbank.

For additional information see www.balkan-observatory.net, www.wiiw.ac.at and www.gdnet.org

BARONS UPRISING

A transition is a set of processes which eventually result in the total change of all segments of a society. It develops in two directions: as a political and an economic transition. The two must advance simultaneously and at similar pace; progress in one direction is not sustainable unless accompanied by progress in the other.

The aspired change is comprehensive by definition, since the transition is a process of passing from one form of organization of society to another, whereby all actors of that society change as well. Is it possible for the change of actors to occur spontaneously? Hardly. Each segment of society will resist change as long as the entire environment has changed up to the point where its very survival is compromised unless it accepts to change. Those who declared reforms their direct objective and receive a mandate from the voting majority to implement these reforms are supposed to pursue changes and create a better environment.

Hence it is futile to expect one segment of society (for example, representatives of big business and high finance) to be capable of changing on its own. Quite the opposite, what is more likely is desperate defense of the environment which enabled them to make big business and generate high finance – why change something that is a proven recipe for (personal) success and benefits?

From “the Mighty” to “the Weak”¹

What are the circumstances for acquiring high finance? The transition in our country has to be deeper than the transition in the rest of Eastern Europe. It does not start from socialism only, but from the final, i.e. degenerative developmental stage of something that used to be referred to as socialism, but was actually a regime that evolved from the rule of a party oligarchy into the rule of one family. The actual prerogatives of that family *de facto* made it an uncontested master of both politics and the economy.

What developed then was the organization of the state typical for every dictatorship: a corporate state. The erection of such a state was to a great extent fostered by war. The type of society established in such a state is similar to feudal society². As in every other feudal society, basic political and economic courses directly depend on the supreme ruler. He is the one to decide who is to do what and who is to manage what. He is the one who directly grants feudal estates to those whom he considers meritorious, thus creating aristocracy.

Similarly to feudal kingdoms, in our country we had a war and a looting aristocracy³. After the October 2000 changes, the former was first to suffer loss in a

¹ Stefan Uros IV Dusan Silni (“the Mighty”) (1308-1355), Serbian king and tsar, under whose rule Serbia reached its territorial zenith, becoming one of the largest states in Europe; Stefan Uros V Nejadi (“the Weak”) (1336-1371), Serbian ruler, Dusan Silni’s son, who was incompetent in sustaining the great empire created by his father.

² The comparison of socialism (although it would be much better to say a corporate state of quasi-socialist type) and feudalism is not new. Leszek Kolakowski was the first to describe socialism as “industrial feudalism”, drawing comprehensive parallels between their manifested forms, for example: the absence of vertical mobility in society, clear distinctions and relative independence of domains in politics and the economy, etc.

³ For details about the looting nature of something that is in our country incorrectly referred to as “primitive accumulation of capital” and its mechanisms, we recommend *Mladjan Dinkic “Economy of Destruction”*. The relation of “entrepreneurs” and the state administration toward the national economy

political sense, due to pressure from the international community. This could not be said for the latter. It continued to operate under new authorities, only the supreme ruler was changed. What is more, the supreme ruler rapidly evolved from a collective to an individual during the past three years.

Following the feudal analogy, a turning point in the pre-development of the transition in our country could be characterized, without exceptions, as barons uprising against the ruler. We are not very likely to find out whether this concerns the uprising of the war aristocracy trying to resume its position in politics, or the looting aristocracy trying to defend its economic interests from politics.

A step from “the Mighty” to “the Weak” turned out to be small, unlike the price paid for such discovery. The insignificance of that step shows up constantly, almost on a daily basis, from institution to institution, as they self-destruct from sheer emptiness and impotence. The smaller the step, the bigger the price – from the life of the Prime Minister of one country to its economic life. What remains are political, and above of all, economic activity, which are under the barons’ control is. The corporate state has confirmed its presence once again, threatening to compromise the modest transition that has been begun thus far.

Profit and Development

How likely is it that aristocrats without the ruler will transform into tax-paying capitalists? Into those who understand that the function of profit and the function of development must go in the same direction, with both profit and development being compromised otherwise? The answer is, of course, negative, as long as the political and economic environments remain as they are today – without institutions, without competition, without reforms.

There are attempts to defend the *status quo* by using another analogy, but they simply cannot be applied here. Namely, examples of big entrepreneurs and bankers from Western Europe and the United States, who acquired their initial capital in a manner that in no way can be described as “gentle”, which does not prevent them from playing a vital role in future economic development. This is a shallow remark, which probably deliberately does not take into account the basic difference between first days of capitalism in the West and what is happening in our country.

Capitalism in the West developed out of the fight against feudalism mainly through uprisings against rulers and the aristocracy. And for this reason the spirit of a capitalist is enterprising and active, developed out of the fight against the privileged. That spirit shows up both in conquering new spaces and markets⁴, and in establishing common institutions which serve everybody’s needs, and not only those of the ruler and the aristocracy.

Our tycoons were created from their direct relation with the privileged. They are not familiar with institutions – they themselves are institutions in their own domain, their monopoly. The transition as a process is far from a bourgeois revolution in its methods, but in terms of goals, they are the same. The method that should be enforced in the transition today is the change of environment, including institutional capacity building, and immediate decentralization and liberalization of all processes, both political and economic. This is the only way to put social wealth, which is currently under the control of tycoons, in the service of development of the national

and society in general continued to exist throughout the 1990s, including the period after hyperinflation.

⁴ The enterprising and free spirit of capitalism was best described by Hayek in “Road to Serfdom”, in his discussion of the role of traveling merchants (“les pieds poudres”)

economy. Without pressure of competition on one side and tax administration on the other, the situation will not change, while our economy continues to suffer the flight of capital at the national level⁵.

The Court Intelligentsia

Why then is this not happening to us? Of course, tycoons do not rule directly. More precisely, they rule directly in their domains, the domains that take the form of a monopolistic position in a specific economic activity. At the level of the state as a whole, i.e. as a totality of political and economic activity, they rule through a segment of society that is similar to a feudal court camarilla. What is more, the court camarilla is to a great extent a factor which facilitates the sustaining of continuity with the governance of the previous regime.

This opinion does not refer to the state apparatus itself, which has all the reasons to resist the change of environment. The social segment we are talking about exists at the top or near the top of that administration pyramid. Some senior experts involved in the administration permit their expertise to be abused by giving legitimacy to wrong and damaging policies. They also permit their expertise to be directly placed in the service of disintegration of the economic and political being of the nation, submitting it to the tycoons' interests.

Here we can also draw a parallel with independent experts in the West. As the ideologue of capitalism, the Western intelligentsia from the beginning of the modern era assumed a position against state authorities from that period. And such a critical position has been maintained for the most part until today.

Quite the opposite, circumstances in Central and Eastern Europe defined the intelligentsia as predominantly courtly, as part of a camarilla⁶. This social segment in our country today has assumed an almost grotesque form, as "independent" experts, whereby independence does not refer to the independence of spirit, but to readiness to equally represent a different position, depending on who gives orders at court. "Independence" of our consultants⁷ is thus reflected in their ability to act, without shame, as advisers and collaborators of a dictatorship, and to be at the top of the pyramid of state administration, which is turning into a service for barons.

The change in the environment toward transitional objectives – a market economy and political liberalism – by no means can be driven by either barons or experts from the camarilla. The former because they have no interest in it. while the same applies to the latter, except that for lack of interest, they are shallow both in terms of expertise and intellect. The lack of ethics cancels the entire expertise.

After all, how could it happen otherwise that, with all references to reforms, we are returning to the position of a corporate state? The difference in the manifestation of this phenomenon so far is that it is no longer socialist in nature, with impersonal bureaucrats acting as heads of particular segments of the economy and society, but is beginning to resemble other countries in which governing parties and big business together have parceled out the national economy. And this is far from all freedom and

⁵ Such a negative model functioned and is still present in many Latin American countries. One of its features is permanent susceptibility to crises and permanent pauperization of entire nations.

⁶ An example of the exception to this "historical rule" would be the intelligentsia of Poland in Balcerowicz's government. However, there the political elite open-heartedly accepted reforms and began the dismantlement of the quasi-socialistic cooperative state.

⁷ A consultant is a person whose job is to give advice in exchange for financial compensation. Accordingly, a consultant is by definition in someone's service. Hence, an "independent consultant" is a contradiction *in subjecto*.

democracy, which are essential for liberal capitalism as an order which is based on free initiative and equal rights for all, without privileges.

ISSUES CONCERNING THE MATURITY OF SERBIA AND MONTENEGRO FOR EU MEMBERSHIP (COPENHAGEN ECONOMIC CRITERIA)*

Sub criterion 1: Existence of a Functioning Market Economy
To what extent has liberalisation been completed in the area of prices and foreign trade? What is left to be done in these two fields?

The liberalization of prices has been realized to a great extent. After the liberalization of food prices, other prices that used to be under administrative control have been gradually liberalized, as well. The Government still controls the prices of petroleum and petroleum products, human medicines, flour and bread made of the type 850 flour. The prices of electricity, gas, heating energy and transport and postal services produced by public enterprises, are under administrative control, as well. This also applies to the prices of basic public utilities (water, garbage collection, heating public transportation) and the prices of domestically produced coal for households.

Foreign trade liberalisation encompassed the liberalisation of procedures, abolition of quotas and other non-tariff restrictions, as well as reduction in tariff rates for the majority of products. What appears to be the problem is that there still does not exist a unique customs territory. Kosovo has customs office separate from the rest of the country, while Serbia and Montenegro are in the process of establishing common customs territory, although there are several products for which tariff rates have not been agreed upon yet.

Are there still barriers to market entry (establishment of new firms) and exit (bankruptcies, liquidations)? Are the respective regulations in force, if yes, to what extent can they be enforced?

FRY Law on Enterprises (amended in 2002), which is currently the applicable company law in Serbia, regulates the status of economic entities. It contains basic provisions on the establishment, capital formation and management of economic entities. The legal forms of enterprises in the Law on Enterprises are broadly equivalent to prevailing EU states' categories, with the exception of socially-owned companies and public corporations. An enterprise acquires legal personality when it has been registered with the commercial court registry, and is terminated when it has been deleted from the court registry. The register is kept with the Commercial Courts of first instance, and the procedure of company registration is regulated by Law on Court Registration (1994).

The new Draft Law on Company Registration entered parliamentary procedure in June 2003. It is a reflection of the World Bank Report which recommended an overall revision of the business registration system, including the elimination of the

* Prepared by the team of G17 Institute researchers, on the basis of papers: "Cost of Doing Business in Serbia II", "The Analysis of the Competitiveness Factors of Serbia and Montenegro", produced by G17 Institute, and SCEPP reports on several sectors.

registries from the commercial courts. The aim of the new legislation is to simplify the registration of both enterprises and entrepreneurs by creating a central registry with a database for companies in Serbia. According to the legislation in force today, the company, once registered with the Court Register is normally unable to commence its business activity until it obtains various certificates from relevant state bodies confirming the fulfilment of the prescribed conditions. Official time period necessary for this to be completed averages 71 days, but there is an inbuilt waiting period in these procedures of some 105 days on the average. The longest registration procedure in Serbia took 5,540 days. The new Draft Law on Company Registration provides for the register to be managed by the Agency for Commercial Registers (through registrars) which will allow the submission of registration applications to be carried out directly to a branch office of the Agency or by mail. The Agency shall thus perform the activities which are now done by commercial courts and municipal authorities. A registrar, appointed by the Government of the Republic of Serbia, shall carry out the registration. The Draft Law foresees the following information to be included in the Register: the name of the company, the seat of the company, founding date and time, the date and time of registered changes, the registration number, tax identification number, form of conducting commercial activities, line of business and bank account number.

Dissolution is regulated by common provisions as to the ground for liquidation and bankruptcy, whereas the Law contains specific rules on dissolution of each legal form of company. Dissolution must be reported to the Court Register. It is further governed by the Serbian Law on Compulsory Composition, Bankruptcy and Liquidation (1996). The new draft Law on Bankruptcy is at the stage of final drafting. The Draft Law provides for more efficient bankruptcy procedure by, among other things, setting time periods and deadlines in which courts shall finish the entire process. It also puts emphasis on the authority of creditors and bankruptcy administrator, sets out the requirements for appointing licensed administrators and introduces the concept of reorganisation within bankruptcy procedure.

The Law on Enterprises which is currently in force in Serbia creates a basic legal framework for operating companies in market conditions and it essentially follows the company law concept in the EU. However, this law is much broader than the traditional company, law and it needs to be further developed in order to achieve simplicity, transparency and consistency.

The entry of foreign banks was one of the crucial events for restoring the confidence in banking system, and resulted in an increase of foreign exchange savings.

At the beginning of economic reforms, foreign banks could set up banks locally on the basis of a licence issued by the National Bank of Yugoslavia. However, the Central Bank has publicly stated that it will not issue new licences in the future, so that the only way for foreign banks to enter the local market will be to purchase local banks (either small private banks unable to meet the new capital requirements or state-owned banks that are being privatized). Folksbank has recently purchased Trust Banka, as the minimal capital requirement was raised from EUR 5 to EUR 10 million. Of the three banks that are scheduled for privatization in 2004, Novosadska Banka is expected to be sold to Uni Bank, Kontintal Banka to Nova Ljubljanska Banka, while we do not have information who is seen as prospective buyer of JuBanka.

The entry of foreign providers of financial services is possible only if the firm is founded as a domestic legal entity, and it is subject to the domestic legislation as is the case with banks and all other enterprises founded by foreign capital (the term

“foreign” is used to denote an entity which is established with the initial investment of foreign capital) Four “foreign” brokerage houses are currently present on the local market: three from Slovenia and one from Hungary.

Between EUR 50,000 and 300,000 are required for the setting up of a brokerage house, depending on the range of planned activities (activities could range from just performing trading activities to portfolio management, investment advising and underwriting of new issues). Approximately 170 brokerage houses operate in Serbia today (a significant increase from 70 in early 2001). This number is expected to drop substantially once the new law comes into effect, as the most of them will not be able to meet the capital requirements.

The restriction to the entry of foreign securities services providers is officially explained by the fact that excessive entry could threaten financial stability by drawing out the scarce domestic financial potential. In the long run, increase in the readiness to sustain competition should stabilize the financial market. Currently the government has no interests in participating in this sector, besides the initiative to transform parts of the former ZOP (centralized institution previously in charge of payment operations) into rating agencies. However, privatization in this sector is not likely to bring significant revenue.

In practice, foreign investors usually choose to incorporate a limited liability company (d.o.o.), due to the fact that minimal obligatory pecuniary part of the initial capital of a L.L.C shall not be less than the dinar equivalent of US \$ 5,000, while the limited liability company may have not more than 30 members, and the risk for business operations of the company is limited to the amount of their investment.

A representative office in FR Yugoslavia may be opened by:

- one or more foreign persons engaged in an economic or banking/financial activity and/or insurance;
- any national or international organization whose members are foreign persons engaged in business operations;
- any national or international organization working towards the advancement of trade with Yugoslavia.

The representative office does not have the status of a legal entity; it may have one or more branches in Yugoslavia. The representative office cannot be opened in the field of armaments and military equipment.

The representative office may start working after being registered with the Register of Representative Offices of Foreign Persons in Yugoslavia, which is kept by the Federal Ministry of International Economic Relations, and may perform only the activities for which it is registered.

This Law defines a foreign investment in the Federal Republic of Yugoslavia as follows:

1. Foreign investment in a Yugoslav company by which investment the foreign investor acquires a stake or shares of the basic capital of the Yugoslav company;
2. Acquiring any other property rights of foreign investor by means of which the foreign investor realizes his business interests in the Federal Republic of Yugoslavia.

Company with foreign investment enjoys equal legal status and carries out its business activities under equal conditions and in an equal manner as do Yugoslav companies without a foreign investment. A foreign investor enjoys full legal security and legal protection in respect of rights acquired by virtue of the investment. The rights of foreign investor acquired in the moment of registration of the legal documents cannot be deteriorated by subsequent alteration of laws and other

regulations. The investment of a foreign investor and assets of the companies with a foreign investment cannot be expropriated, nationalized, or subject to other acts of the State of equal effect, unless when the public interest is established by the law or based on the law, and against payment of a compensation. Compensation must correspond to the market value that the investment has on the day of the act of expropriation, nationalization, or other measure. The change in the investment value that may occur due to the fact that public has learned of the expropriation, nationalization or other measure, shall not have impact on the investment's market value estimation carried out for the purpose of payment of the compensation. Also, compensation must be paid without delay in convertible currency and the foreign investor may freely transfer it abroad. In the case of delay in the payment of this compensation the foreign investor is entitled to the statutory interest.

Finally, a company with a foreign investment, apart from bookkeeping and financial reporting obligations in compliance with the domestic law, has the right of bookkeeping and making financial reports in compliance with the internationally recognized accounting and auditing standards.

Registration – facts

1. Registration of enterprises

In the stage of registration of an enterprise the requirements are as follows:

- a) Application to the court register kept by the jurisdictional commercial court;
- b) Application to the Republican Statistical Office;
- c) Opening a transfer account with a commercial bank⁸.

The pecuniary founding portion of the fixed assets of a limited liability company **may not be smaller than USD 5,000** in dinar countervalue on the day of payment.

The pecuniary founding portion of the fixed assets of a joint-stock company established simultaneously **may not be smaller than USD 10,000** in dinar countervalue on the day of payment.

The pecuniary founding portion of the fixed assets of a joint-stock company established successively **may not be smaller than USD 10,000** in dinar countervalue on the day of payment.

2. Registration of banks and other financial organisations

The application for inscription of a bank in the court register is to be submitted **within 45 days from the day of receipt of the decision on issuing the operation licence** whereby the National Bank of Serbia has established that legal requirements have been met and that founding the bank is justified.

The following documents are submitted together with the application for inscription in the register of the Commercial Court:

- the contract on founding;
- the bank's articles of association;
- evidence that the founders of the bank have paid in appropriate funds as founding capital to the suspense account with the National Bank of Serbia, or evidence that a foreign person has paid in the foreign exchange to a special account with the National Bank of Serbia;

⁸ Pursuant to the new Law on Payment Operations, effective as of 1 January 2003, accounts of enterprises are kept with commercial banks, with a possibility of opening several accounts with one or more banks.

- evidence that the founders of the bank are transferring non-pecuniary assets to the founding capital of the bank and evidence by a licensed assessor on the assessment of non-pecuniary assets;
- the decision of the National Bank of Serbia on issuing the operation licence and the consent of the National Bank of Serbia to the bank's contract on founding and articles of association;
- other documents in accordance with the regulations on inscription in the court register.

Other financial organisations acquire the status of legal person with the inscription in the court register. The application for inscription of other financial organisations in the court register is submitted in the manner and under the conditions provided by law.

The application for inscription of an exchange in the court register is submitted upon obtaining the licence for its founding, issued by the Republican Commission on Securities.

With the application for inscription in the register of the Commercial Court **the founders of an exchange submit:**

- the licence to found the exchange;
- the contract on founding;
- the articles of association;
- the rules of the exchange;
- evidence that the obligations from the contract on founding have been met.

The costs of founding an exchange with the Commercial Court are identical with the costs of founding other forms of enterprises, excluding the costs provided as a requirement for obtaining the operation licence from the competent commission, which are dealt with in the next chapters.

3. Conclusions and recommendations concerning the process of registration

Successful and fast registration of business operations at minimum cost would constitute a true model of commencing operations for any business subject. However, at the very outset the business subjects encounter numerous problems.

The Commercial Court keeps records on all the enterprises in separate registration files, including numerous forms. This method of keeping records on the subjects of inscription **makes it almost impossible to enter regularly and promptly the data on the changes that the enterprises make in their legal life.** These changes include the change of the manager, of the enterprise's address, of the structure of the founding capital etc. Furthermore, it is almost **impossible to obtain promptly the data on an enterprise**, as such a request involves the concerned person's going to the Commercial Court and direct insight in a heap of papers. Furthermore, very often it is impossible to find some of the data, as more often than not the file on the subject of inscription is held by a judge of the Commercial Court, from whom the required information cannot be extracted because of his being too busy. Such cases are a rule, as in most of the cases the sought subject of inscription is an enterprise where bankruptcy proceedings have been instituted and the persons seeking the data are the creditors of the enterprise who are extremely interested in its destiny.

As a basic innovation in this field we propose the keeping of the inscription book in the electronic form, which would provide that all the data on economic entities for which the Commercial Court is competent are available in the electronic form to all the interested subjects. The term "concerned person"

means natural persons, government authorities, chambers of commerce and industry and foreign investors, who would have easy computer access to the inscription book. This book, with the data it contains, would be an integral part of a common information system. In addition to data on the subjects of inscription for which the Commercial Court is competent, this information system would be a point of convergence of data on other economic entities whose inscription is the competence of administrative authorities (municipalities for handicraft trade, the Ministry of Justice for non-governmental organisations).

Such solutions would substantially **promote the registration procedure**, both in terms of its speed and in achieving the usefulness of the register as a comprehensive base of data on economic entities indispensable for establishing normal business activities of both local and foreign investors.

To what extent does the legal system, first of all the regulation of property rights, correspond to the requirements of a market economy? Can laws and contracts be enforced?

Bankruptcies and liquidations

The Law on Compulsory Composition, Bankruptcy and Liquidations which is currently in force was passed in 1989. The new law which designed to meet Western standards was projected to be adopted in late 2003. However, since the Parliament was dissolved and the new parliamentary elections scheduled, the adoption of this law will be postponed to the first quarter of 2004.

The new Law shall enable creditors to collect their claims quickly (in 30 days at longest) and efficiently. It does not foresee the institution of "working liquidation"; therefore, as soon as the company becomes unable to meet its obligations, it will go bankrupt. Since current Law does not limit the duration of bankruptcy procedure, they usually last for more than one year. Similar to the US law, a special institution shall be set up to try to recover bankrupt companies. Precise procedures and the roles of all parties involved will be laid down by the law. Once bankruptcy procedure begins, all employees will not automatically lose their jobs. The procedure can be initiated by the debtor, the creditor and by the government bodies.

The current Law has been greatly abused by those who have strong connections to officials at the Commercial Court. Companies that possess substantial assets (individuals with very market value such as prime real-estate) have to enter bankruptcy procedure even for very small debts. Also, the acquisition of Sartid, Smederevo by the US Steel has not been bid welcome, as many believe that Sartid could have been privatized at a much higher price if it had been sold by the means of auction or tender and not through the bankruptcy procedure. Finally, the Commercial employed has only one person performing the duty of bankruptcy administrator for 63 companies, which is too complex duty to be done by only one person..

**Concerning macro-economic stability, to what extent is inflation under control?
Are public finances and external accounts sustainable?**

After the liberalization, annual inflation rate was reduced to a sustainable level with regard to the objectives of monetary and fiscal policy. Annual inflation rate was 70% in 2001; it dropped to 19.5% in 2002, whereas in 2003, inflation rate is projected to be 12%. However, inflation in Serbia is still high as compared with the neighboring countries which are candidates for membership in the European Union. The deceleration of inflation with a view to maintain it at one-digit annual rate in part depends on the dynamics and volume of increase in prices of energy sources, which are under administrative control, as well as on trends in prices of imported products.

Sub criterion 2: the ability to withstand competitive pressures and market forces within the EU

Is human and physical capital, including infrastructure (energy supply, telecommunications, transport etc.), education and research available in sufficient amount and at an appropriate cost?

Physical facilities are generally in poor condition, and although they have been undergoing restructuring, there is still plenty to be done, both in terms of upgrading the existing infrastructure and building new facilities. Education level is generally satisfactory, but the problem is insufficient collaboration between companies and research and academic institutions.

What is the state's contribution to the competitiveness of economic agents in your country through trade policy, competition policy, state aid and support for SMEs?

Trade, industrial and agricultural policy, as the main elements of economic policy, are not well-developed, or do not exist at all. Certain state aid is coming through, but it is usually very limited and more oriented towards subsidizing public enterprises in restructuring, than towards supporting SMEs.

How far has trade integration with the EU progressed concerning both trade volume and composition of trade?

The EU countries represent major trading partner of Serbia, constituting around 50% of both commodity exports and imports. This share will be even higher in the future, when candidate countries accede the EU. However, both volume and composition of exports are rather unfavourable for Serbia, since exports mainly consist of agricultural products, raw material, semi-finished products and labour-intensive products.

ISSUES ADDRESSED CONCERNING THE POTENTIALLY DIFFICULT CHAPTERS AT PROSPECTIVE ACCESSION NEGOTIATIONS WITH THE EU

Free movement of goods

**How far has free trade in industrial goods with the EU been implemented?
To what extent has agricultural trade been liberalised?**

Serbia and Montenegro have been granted autonomous trade preferences, so that almost all products (except textiles, steel, wine, baby beef and some fishery products) are imported duty free into the EU. However, significant non-tariff barriers are still in place. On the other hand, imports of industrial products are free, while agricultural products may be subject to seasonal tariffs.

Free movement of persons

**What is the assessed outward migration potential of your country?
How high/low are the wages in Euro and PPS (power purchasing standard / power purchasing parity (PPP) in your country compared to the current accession countries? How serious is unemployment compared to the accession countries?**

Unemployment rate in Serbia, as compared with countries which are due to accede the EU in the first circle of enlargement is much higher.

Unemployment rate, in %

	Slovenia	Hungary	Czech	Lithuania	Poland	Slovakia	Srbija
2000	7.2	9.1	8.8	15.4	15.1	17.9	25.6
2001	5.9	8.4	8.9	17.0	17.3	19.8	26.8

Bearing in mind that Serbia is in the process of transition, basic characteristics of its labour market resulting in the current state of affairs are the following:

- Large and durable registered unemployment;
- Hidden unemployment in state-owned and socially-owned enterprises - the share of fictitious employment in the total employment is estimated at some 30%-40%;
- Drop in registered employment reflects in the decreasing number of employees in the socially-owned sector;
- The structure of the unemployed is dominated by those unemployed for several years (the highest share of the unemployed seeking for jobs for one to three years), young persons between 15 and 34 years of age, those with secondary education and those seeking for their first employment;
- The structure of the employed is dominated by persons between 35 and 54 years of age, workers with secondary education. As for the structure of the employment according to the pension tenure, the major share is taken by those with 21 to 30 years of pension tenure, while concerning the structure of the employed according to the ownership of the companies in which they are employed, the majority of the employed work in the socially-owned and state-owned sector;
- The loss of human capital – hundreds of thousands of young persons moved out of the country during the last decade, and for this reason it is necessary to

create conditions in which it will be more profitable for the youth to stay in the country, i.e. to create such a setting which will be more appreciative of knowledge and skills.

As far as the gross wage is concerned, as of June 2001 a new accounting methodology is applied on calculation of wages. Following the new methodology, the average gross wage in 2001 was YuD equivalent of EUR 147, while in 2002 it was EUR 218.5, 49% year-to-year increase.

Average gross wage – annual breakdown, increase in % relative to the previous year

	Slovenia	Hungary	Czech	Lithuania	Poland	Slovakia	Srbija
2001	11.9	18.2	8.6	2.1	8.0	10.5	52*

* Data refer to 2002.

The Table shows that Serbia registers much more intensive growth in gross wages at an annual level compared with other countries under consideration, which is a result of the reforms initiated in October 2000. High growth in wages in Serbia result in part from faster increase in wages of the workers in public health services, education and the judiciary, which used to be unjustly depreciated, and in part from the new Labor Law, which gives the employer much more freedom and flexibility in setting individual wages.

Free movement of capital

To what extent has capital movement been liberalised?

Accessing foreign capital is allowed to domestic banks through equity investments, and through borrowing. Equity investments in domestic banks are allowed to all banks subject to NBY approval and borrowing is allowed only to banks authorized for cross-border banking. An authorized bank shall be a legal entity established and doing business pursuant to Law on banks and other financial organizations and possessing an authorization issued by NBY to carry out foreign transactions. In order to obtain authorization for performing foreign payment and credit operations (full authorization), a bank must have an amount of at least 6.0 million US dollars on its foreign exchange accounts. In order to obtain authorization for performing foreign payment operations (middle authorization), a bank must have an amount of at least 4.0 million US dollars on its foreign exchange accounts. A bank shall be a legal entity established and doing business pursuant to Law on Banks and other Financial Organizations, not possessing an authorization of NBY to carry out foreign transactions.

Along with the equal legal treatment of foreign and domestic banks, there is also no distinction within the forms of ownership. The banks (either domestic or foreign) are allowed to hold equity in financial and non-financial firms with a limitation that the participation of a bank in the capital of a legal entity cannot exceed 15% of the bank's capital. Another limitation is that participation of a bank in the capital of legal entities and its investment into fixed assets cannot exceed 60% of the bank's capital in total. But also an acquirer of shares shall be obliged to obtain an approval from the National Bank of Yugoslavia for acquiring bank's managing shares entitling it to 15% participation in the bank's equity capital, as well as for each increase of that participation.

The foreign investor may freely convert domestic currency into foreign convertible currency as regards each payment related to the foreign investment. A

company with a foreign investment is free to perform payments in its international business relations. A company with a foreign investment may keep foreign currency on a foreign currency account with an authorized bank and may freely dispose with those resources.

Fully convertibility of the dinar for current and capital transactions with foreign countries can be expected in the future as this will allow for foreign trade to be undertaken more easily and efficiently.

Upon settlement of the obligations according to the domestic law, a foreign investor may, freely and without a delay and in a convertible currency, transfer abroad all financial and other assets related to the foreign investment, and particularly:

1. Income derived from the foreign investment (profits, dividends, etc.);
2. Property belonging to him upon termination of the subject of the investment or based upon the termination of the investment agreement;
3. Amounts received from the sale of stake or shares of the company with a foreign investment;
4. Amounts acquired on basis of a decrease of the basic capital of a company with foreign investment;
5. Additional payments;

To what extent is money laundering under control?

The following regulations govern the financial sector in Serbia: The Law on the National Bank of Yugoslavia, the Law on Banks and Other Financial Organizations, the Money Laundering Act, the Foreign Exchange Law, the Law on Securities and Other Financial Instruments Market, the Law on Securities Market.

The isolation of Serbia during the 1990s brought about enormous grey economy and the practice of questionable money transactions was widespread because of the fear of the government and the lack of trust in local banks. Under the current law, which has been in force as of July 1, 2002, money laundering is defined as attempting to legalize funds acquired from activities in grey economy and from trade in arms, drugs and other forms of contraband. For the bank deposits of YUD 1 million or more, the depositor is required to produce the proof of origin of the deposited funds.

Under the law, tax authorities send to the tax police documentation showing that tax on one particular income has not been paid. On that basis public prosecutor issues a criminal indictment.

Penalty foreseen for tax evasion is one to ten years' imprisonment, while all illegal funds are confiscated.

Necessary regulatory acts exist, but nevertheless, money laundering is not under control. The Janjusevic-Kolesar case shows that money laundering is present even at the highest levels of state administration. However, it was G 17 PLUS and not state authorities who made this case public, which shows that a long way towards the strengthening of public institutions lies ahead of Serbia. Only by the strengthening of official institutions and introducing stricter penalties for illicit activities will this global problem be brought under control in Serbia.

For example, the capacity of retail stores chain 'C Market' for money laundering is very high since it has YUD 30.000.000 daily cash inflows.

What is the population's attitude towards selling agricultural land and second homes in holiday resorts to foreigners without restrictions once the country is member in the EU?

This subject is not in the public's focus. The public only considers the price which is offered for the property they offer for sale and have not reservations about selling to foreigners.

Competition & state aid

Is the economy of your country sufficiently mature to transform prevailing non – EU compatible subsidies granted to domestic state and private companies and foreign investors to EU compatible ones? Is there a road map to achieve EU compliance in this matter? How far is the current level of deregulation in the economy from the level required from EU members?

The State Union Serbia and Montenegro, both as an economic entity and as a state, is not "mature enough" at the moment, i.e. it is not able to accept the EU-compatible system of state subsidies. This results from the fact that Serbia and Montenegro do not have appropriate mechanisms and institutions, congenial to those existing in the European Union, to ensure efficient distribution of these resources to end users. It is well-known that the management of EU resources and funds was the most difficult issue during the accession negotiations between candidate countries and the European Union, for this reason being left to be discussed at the final stage of negotiations. As our country is at the very beginning of the long process of association to the European Union, and as it has not established official bilateral relations with the Union yet (the Stabilization and Association Agreement has not been signed), inexistence of the EU-compatible mechanism of subsidies is not surprising.

Also, there is no a road map designed with a view to reach EU standards in this matter in a defined time framework. The road map does not exist due to the lack of financial resources. Abundant state subsidy and financial support are possible only providing efficient national economy, which is not the case with Serbia and Montenegro.

Agriculture

How far apart are the quality standards in meat and milk production, horticulture etc. in your country from those required in the EU? Is the farm structure compatible with the subsidisation philosophy of CAP (very small farms are excluded)? Is there absorption capacity available for SAPARD type transfers and transfers for rural development?

Serbia has three agricultural regions – Vojvodina (fertile plains with the production of cereal, industrial crops, etc.), Central Serbia and southern Serbia (mainly mountainous, production of meat, milk, etc.). Cereals, industrial crops and fruits and vegetables are the key crops of Serbian primary agriculture. The former Yugoslavia had a good tradition in the agro-processing sector. At the moment, many of these enterprises are not working at all, or operate only with portions of their capacities. Some of the reasons are that those enterprises are not privatised yet, and they need considerable amount of investments, new marketing strategies, while the sanitary, phyto-sanitary and food safety system in Serbia does not allow the export of

processed food. Most of these enterprises were part of large agricultural combines connected to a strong branch of primary agricultural production.

The majority of agricultural operations in Serbia form small scale, family based farms – 80% of the agricultural land in Serbia is privately owned. Average farm sizes are fairly small (about 4ha in Serbia). In Serbia about 20% of cultivated land belongs to state owned enterprises and cooperatives. The number of the state owned enterprises in primary agricultural production, which is changing permanently during the process of privatisation, reached 328 in January 2003. These companies employ about 70,500 people and some of these enterprises own far more than 10,000 ha. There are 241 agro processing enterprises in the process of privatisation which employ nearly 75,000 people. These large enterprises will have to compete with larger scaled units in the EU and need an adequate environment to raise their productivity. Serbian family based agricultural operations, most of which not being enterprises in a formal sense, are less export oriented. To empower these farms for the future, different strategies will need to be developed.

Serbia has the potential to be a food exporter. In 2002 this became evident with an increase in exports of some 330 million and with a trade surplus in agriculture of nearly 150 million. Main export products are fruits and vegetable (40% of export volume account raspberries, and cereals for 20%).

There are two types of legal problems that need to be addressed quickly to provide a solid base for agricultural strategy of Serbia. First one is that there is a general problem of the registration of land ownership, which derives from neglected or non existent regulation and procedures for 50 years. The second legal problem is the composition of the property of state owned combines (kombinati), and partly of cooperatives. The property of these entities is partly composed of land that was confiscated and at least some portions of that land will be the subject of another wave of restitution claims.

Taxation

Is the taxation system EU compatible?

The taxation system is not EU compatible; the main reason is the fact that the VAT does not exist in Serbia.

If not, what steps are necessary?

The first step is to introduce the VAT, and after that to implement this taxation system in Serbia, as it seems it will not be possible to implement smoothly in, at least, next 6 months. The introduction of the VAT is on the third place of the required reforms needed to be implemented by Serbia so as to be taken into consideration for EU membership. The law which is expected to come in effect has been condemned that it will take long for funds to be returned, when taxing investment goods 20% of the funds will be a minimum for 45 days out of the hands of the producer, which will slow economic activity. Also, if the government does not return the funds within the legal required time they will not be sanctioned nor will they have to pay interest. Exports will not be taxed while imports will be.

Is the economy sufficiently mature to function smoothly under an EU compatible taxation system?

The tax system in the Republic of Serbia is regulated at the level of the Republic. Detailed tax regulations, tax collection and control of tax compliance are in the competence of the Republic. The effect of this is that the corporate income tax, personal income tax, turnover tax as well as other taxes are levied at the level of the Republic. Extensive tax reform was implemented in June 2001. Almost all the laws were revised, and in many areas new rates were introduced. In addition, some new taxes (such as the use tax) were introduced. In November 2002, new amendments were adopted, resulting in lower tax rates and a more favourable tax and business environment.

A foreign investor and a company with a foreign investment enjoy tax and customs benefits in compliance with the law.

Importing (new) equipment on basis of the investment share of the foreign investor, except for motor vehicles, fun machines and lottery games, is exempt from customs and other import duties. The right may be used according to the determined investment dynamics up to the time of the completion of the objects being built or a beginning of an activity into which the investment is being made or if the investment is being made on a basis of the profit reinvestment - throughout the validity of the contract or the agreement. Customs exemption may be also used by a company with a foreign investment to the limit of the foreign investment and for the period of two years from the day of the registration of the foreign investment.

Energy

Is there a nuclear power station in your country? If yes, is it compatible with EU safety standards? If not, is there a viable solution to that problem?

Approximately, 95% of the electric energy generated in Serbia is produced by large enterprise producer (Elektroprivreda Srbije) – some 62% of electric energy generated by this enterprise is produced by thermo electric generation plants using lignite, the main reserves of which are situated on the territory of Kosovo. The lignite resources on Serbian soil may only be sufficient for about 30-40 years. Generators driven by hydropower produce 37% of electric energy. Therefore, this kind of generation is an important resource for the Serbian economy and provides the potential to reduce average production costs. The equipment used for the generation of electric energy was bought between 1970 and 1990; from the beginning of 90s there was a very low level of investment and even major repairs were not undertaken.

Serbia produces about 20% of the oil consumed in the country from its own oil wells. The existing wells are reducing their production and new wells were not explored during the last year. Large percentage (about 80%) of crude oil is imported and Serbia is served by a pipeline coming from Rijeka in Croatia. There are two refineries, producing 4.82 and 3 million tonnes per year. Of this output, some 92% is used as for petrol, diesel, industrial oil and lubricants, and 8% is used for chemical production. The oil processing sector is clearly uncompetitive largely due to the low quality of the oil derivatives produced.

Only small amount (20%) of local gas consumption is produced in the country – and this activity is declining by about 10% per year. 80% of natural gas comes from

import, mainly from Russia, and it is transported by the gas pipeline crossing Hungarian/Serbian border.

Faced with difficulties in the energy sector, energy conservation and efficient use of energy are important policy concerns. Serbia is at an early stage of development in regard to energy conservation, energy efficiency and the use of renewable sources for energy generation. These are some of the questions which will be addressed in Energy Law set, which is supposed to be adopted soon – the harmonisation of a joint energy market in Serbia and Montenegro and a joint energy policy still has to be done.

Regional policy

Is the regional administrative structure of your country compatible with the EU requirements in this field?

The Law on Local Self-Governance, adopted in February 2002, decentralized the administrative structure. It gave the local communities more prerogatives in both governing and financial spheres. The Law was harmonized with the 1985 Local Self-Governance Charter and its major principles.

At this moment, Serbia is divided into regions which have no substantial autonomy, but it is expected that the upcoming constitutional reform will foresee new regional division which will give to the regions more autonomy. The same will happen with the province of Vojvodina, which will most likely be granted substantial political and financial autonomy.

Can potentially necessary changes in this area be made acceptable to the population?

The population has embraced the administrative reforms so far, and it will welcome the announced changes and deepening of the local autonomy.

Is public finance in your country able to provide co-financing to EU projects?

Local communities have the right to retain the part of tax revenues, whereas the state budget is under obligation to financially support all other obligations of local communities if they cannot be delivered by local bodies. It is able to co-finance EU projects.

Environment

What role do low environmental standards play in competitiveness of domestic firms and in attracting foreign investors? Can costs of compliance with EU standards be assessed for the business sector, on the one hand, and for the central and local governments, on the other hand? What transitory regulations would your country need in case of accession to the EU?

According to the Constitutional Charter of the State Union Serbia and Montenegro, the environment is not a subject covered at the Union level. But, the Charter on Human and Minority Rights (as integral part of the Constitutional Charter) has partially compensated for this shortcoming by placing the right to a healthy environment among the catalogue of human and minority rights and freedoms (art. 46). It is without doubt that the entire field of government responsibility for environmental protection comes within the competence of the member states of the

state union, but it is not very clear what government body or mechanism is responsible of coordination between member states and international cooperation.

Serbia has Ministry for the Protection of Natural Resources and Environmental Protection, which prepared Draft Law on the System of Environmental Protection, which is in Parliamentary procedure. According to this Draft Law, following are the short term environmental priorities of Serbia: removal and remediation of ecological hotbeds and prevention of the natural resources destruction, development and strengthening of the institutions and services concerned with the environmental protection, and establishment of a regulatory framework for the system of environmental protection and harmonisation with international regulations. Environmental reform agenda in Serbia also includes the implementation of a programme for solving the problem of inherited cases of pollution, a programme of ecological support to poverty control measures, through the programme of sustainable consumption, ecological support for specific infra structural projects, and the full implementation of international conventions and standards in this area.

Although the legislative situation in Serbia in respect to the environmental protection is relatively good, with more than fifty ratified Conventions and the existence of several national regulations, those regulations are not harmonised and inconsistent, displaying a lack of vertical and horizontal coordination. Namely, there is a strong disparity between legal proclamation and reality – the most serious legal problem is the lack of fully functioning implementation and enforcement strategies and processes.

Justice & home affairs

To what extent is criminality under control? What would be the cost of taking over the Schengen standards on your country's future non-EU borders?

Even though such problems are not unusual for early transition societies, the core of the problem, in Serbia, lies in the fact that criminal elite, inherited from previous regime, is still tied to politics and government institutions and agencies, and that judiciary has tremendous problems with functionality, independence and lack of laws it's should enforce.

In short it would be easiest to say that law level criminality is quite under control, but that sophisticated criminality is still a big problem and that family violence is still on the rise.

The decade of 1990-2000 being cursed with criminality on the national level – known as gray economy, brought many levels of criminal involvement (most citizens where involved in low level criminal activities in order to survive). But, with removal of international sanctions this kind of criminality slowly decreased to a reasonable level. Similar is the fate of most rude and most obvious criminal activities e.g. car theft, armed robberies, assassinations, etc., which came down from rather unbelievable rates for this part of the world at the end of '90s to a regional comparable level.

Often misplaced in this group of criminality is domestic violence, which, due to a recent history of the region, poor economic situation and a lack of the proper social education is still on the rise and is reaching alarming rate.

Unfortunately, the non-so obvious, more sophisticated criminality is still a great problem in Serbia. Those activities including money laundering, illegal transactions, organized crime activities e.g. human and drugs trafficking are still at large even there where quite some efforts by police and intelligence in fight against them.

Even though such problems are not unusual for early transition societies, the core of the problem, in Serbia, lies in the fact that criminal elite, inherited from

previous regime, is still tied to politics and government institutions and agencies, and that judiciary has tremendous problems with functionality, independence and lack of laws it's should enforce.

Customs union

What would be the impact of taking over the relatively low (about 5% for industrial products) external customs tariffs on competitive positions of economic agents in your country?

Taking into account that Serbia and Montenegro are undergoing processes of restructuring their economies, low import tariffs on main imported raw-material, semi-finished goods, machinery and equipment, may be beneficial. However, at this moment there is not enough space for further lowering of tariffs, since tariffs for most of above-mentioned products are already low, while, in order to help domestic producers restructure, tariffs of main exported products should be kept high enough. Another important reason why at this moment further lowering of tariffs is not advisable, is that Serbia and Montenegro do not have well-developed mechanisms of qualitative measures of protection (anti-dumping, technical standards, countervailing measures etc.). Until these mechanisms come in place, tariffs will have to remain main instrument of trade policy.