



EKONOMSKI INSTITUT ECONOMICS INSTITUTE

Ulica kralja Milana 16, 11000 Belgrade, Serbia and Montenegro

Phone: (+381 11) 3613–118, 3612–407, 2688–255

Fax: (+381 11) 3613–467

E-mail: ecinst@ecinst.org.yu

Internet site: <http://www.ecinst.org.yu>

The Measures of Phase I of the Accession Of Serbia and Montenegro to the European Union within the Stabilization and Association Process

Thematic Area: EU Accession Including Euro Adoption

Authors

Prof. Jurij Bajec, Prof. Nebojsa Savic, PhD Nikola Fabris, MSc Jelena Galic,

Dragana Petrakovic, Milan Kovac

This research was supported by a grant from the CERGE-EI Foundation under a program of the Global Development Network. Additional funds for grantees in the Balkan countries have been provided by the Austrian Government through WIIW, Vienna. All opinions expressed are those of the author(s) and have not been endorsed by CERGE-EI, WIIW, or the GDN.

BELGRADE, August 2004 (revised on January and May 2005)



CONTENTS

INTRODUCTION.....	3
I STRATEGIC SIGNIFICANCE OF SM'S ACCESSION TO THE EUROPEAN UNION.....	6
1. SWOT Analysis of Accession to the EU	6
2. The Strategic Objectives of the Forthcoming Economic Development	14
2.1. The Acceleration of Reforms and Transition Processes	14
2.2. Development through European Integration and Development Processes	17
II THE FIRST PHASE OF ACCESSION TO THE EU	23
1. The Process of Harmonization and Measures within the First Phase of Accession to the EU	23
1.1. Description of EU Legislation Regulating the Selected Areas	23
1.1.1. EU Legislation Regulating the Free Movement of Goods	25
1.1.2. EU Legislation Regulating the Free Movement of Capital	26
1.1.3. EU Legislation Regulating Competition Policy.....	26
1.1.4. EU Legislation Regulating Direct and Indirect Taxation	28
1.1.5. EU Legislation Regulating Financial Services	30
1.1.6. EU Public Procurement Legislation	32
1.2. Identification of the Conditions for Conducting the Process of Harmonization	32
1.3. An Analysis of Transition Countries' Experiences in the Process of Harmonization	34
1.3.1. The experiences of selected EITs in the transition process	34
1.3.2. Common Characteristics of the Process of EU Accession	43
1.3.3. Recommendations for Serbia and Montenegro	51
2. Harmonization – Instruments, Institutions and Time–Limits	53
2.1. Free Movement of Goods.....	53
2.2. Free Movement of Capital	59
2.3. Competition Policy	64
2.3.1. State Monopolies and Public Enterprises	65
2.3.2. Government Assistance.....	67
2.3.3. Concentration Control	70
2.3.4. Restrictive Agreements and the Structure of a Dominant Market Position.....	73
2.3.5. The Legal and Institutional Framework for the Implementation of Competition Policy.....	76
2.4. Indirect and Direct Taxation.....	79
2.4.1. Indirect Taxation.....	79
2.4.2. Direct Taxation	88
2.5. Financial Services	92
2.6. Public Procurement	106
CONCLUSIONS.....	112
REFERENCES.....	114



INTRODUCTION

After the tragic events in South Eastern Europe (war, disintegration of the former Yugoslavia, sanctions, economic collapse and the instability of the region) and in an attempt to encourage the stabilization of the region, the EU initiated the ***Stabilization and Association Process (SAP)***, which was proposed for the West Balkan countries (Albania, Bosnia and Herzegovina, Croatia, Macedonia and the Federal Republic of Yugoslavia) by the European Commission in May 1999. Bearing in mind the long-standing instability of the region, a special arrangement for the accession of these countries to the EU was conceived. Namely, apart from satisfying the general (Copenhagen) criteria, it insists, above all, on the political stability of these countries and on their interlinkages. The process also anticipates the conclusion of the ***Stabilization and Association Agreement (SAA)*** – a new type of contractual relationship with the EU, which is aimed at stabilizing the countries in this region through their convergence towards European integration processes.

Serbia and Montenegro lost ten precious years and its excellent initial position for accession to the European Union. After the long period of isolation, the present state union is only at the beginning of establishing a contractual relationship with the EU. The political changes on 5 October 2000 opened a new phase in the relations between the Federal Republic of Yugoslavia and the European Union, characterized by the declarative and practical expression of the need for closer contacts with the EU, thus establishing a partner relationship. Accession to the EU represents Serbia's long-term strategy, whose implementation requires a clear definition of its aims and plans, as well as coordinated activities of all participants in the process.

The confirmation of the Feasibility Study this April was a positive signal in the process of Serbia and Montenegro's accession to the EU. Although the Feasibility Study was obtained by all other countries of South Eastern Europe several years ago, it is of great significance, because it actually marked the beginning of the process of EU accession. It also stipulates the measures that should be implemented so as to begin the negotiations on the conclusion of the Stabilization and Association Agreement, which is the next step in the process of EU accession.

The latest measures, which have been implemented so as to create an appropriate institutional infrastructure for the establishment of relations with the EU, include the adoption of the Action Plan for harmonization of the economic systems of Serbia and Montenegro and the commencement of work on the EU Accession Strategy. The creation of an appropriate institutional infrastructure for the establishment of relations with the EU represents only the first step in the process of integration into the EU. The overall process anticipates the implementation of internal reforms, achievement of a satisfactory economic stability and growth, stabilization of the democratic system and the strengthening of government institutions, including specifically the administration and judiciary.



During the past period, the Government's reform-related efforts were primarily oriented to the achievement of macroeconomic stability, whereby noteworthy results were produced. At the same time, the process of economic transition was initiated, anticipating the long path of transition of the overall economy to a market-based system. The adoption of the EU rules and regulations represents the third step in the process of accession to the European Union, which should begin even before the completion of the previous two steps due to the fact that the adoption of the basic EU standards is one of the basic preconditions for the successful completion of the process of transition and accession to the European Union. The aim of the Study **»Measures of the First Phase of Accession of Serbia and Montenegro to the EU Within the Stabilization and Association Process«** is to provide recommendations as well as the plan of activities in the selected areas, in accordance with the first-phase measures recommended for candidate countries by the EU.

The Study consists of three parts:

- SWOT analysis,
- An analysis of the experiences of other economies in transition and
- Harmonization with the EU regulations in the selected areas.

These three parts constitute a whole, since they point to the areas requiring harmonization and potential threats in the process of accession, and provide a short analysis of the experiences of the countries which have already undergone this process.

SWOT analysis should point to the potential benefits to be derived by Serbia and Montenegro in the process of accession, as well as to the fact that the process of accession to the EU is not painless and that it entails certain threats and «costs that must be paid».

The Study also includes a short **analysis of the experiences of other economies in transition** with a view to pointing to their experiences in the process of accession to the EU. The experiences of these countries are very important for the process of Serbia and Montenegro's accession to the EU.

It is an accepted fact that **harmonization with the EU regulations** within the process of accession is a long-standing and painstaking task. Therefore, as a rule, the member countries are allowed to select some of the priority areas in which harmonization will be carried out first by themselves. In doing so, they take into account their economic, social and political situation, as well as the hitherto results of their reforms. The EU defines some areas as the priority ones and calls for urgent harmonization, that is, the adoption of the international standards. For this reason, the Study **»The Measures of the First Phase of the Accession of Serbia and Montenegro to the EU Within the Stabilization and Association Process«** will be devoted to the following: a free flow of goods and services, free flow of capital, competition, di-



rect and indirect taxation, financial services and public procurement. It is the question of the areas rounding off the market system. Namely, like other countries in transition, at the beginning of its transition process, Serbia still has no fully developed market economy. Since it is expected that the EU will insist just on these areas within the stabilization and association process the study gives the priority to these areas. Should the Government of the Serbia and Montenegro have the agenda of its planned harmonization with the EU before the conclusion of the association and stabilization agreement, as anticipated under the project, the conclusion of the agreement would be greatly facilitated.

In principle, all parts of EU legislation are important and accession to the EU is possible only after a whole set of regulations has been adopted. However, the regulations that should be harmonized with domestic legislation, have still not been presented (in the «White Paper» and its subsequent supplements) as a single list of the regulations of equal importance. On the contrary, it is pointed to the key measures in specified sectors and a suggestion is made as to the order in which harmonization should be carried. The measures of the first phase of accession to the EU are regarded as the priority ones and they should be implemented first in the process of harmonization. In real fact, they provide a basis upon which other regulations will be built later on. These regulations are of lesser priority, but the status of a full EU member cannot be acquired without their adoption. In general, it is the question of measures that must satisfy at least one of the following criteria:

- To provide a general framework for more detailed legislation;
- To deal with the fundamental principles or establishing the basic procedures in the observed area, and
- To be a prerequisite for the efficient functioning of the internal market in the observed area.

Considering the significance of these measures and the need to implement them at the very beginning of the process of harmonization, it is clear why the first-phase measures are the subject of this Study.

In view of the fact that the formal adoption of regulations will not be sufficient to achieve the desired aim, the need for the formation of specified structures and fulfilment of some other other preconditions for an adequate implementation of regulations are emphasized at various places in the Study.

Bearing in mind the relatively low level of knowledge in Serbia and Montenegro about the harmonization measures required for accession to the EU, the aim of this Study is to be a useful guide to the necessary reform-related measures in the observed areas for economic policy-makers.



I STRATEGIC SIGNIFICANCE OF SM'S ACCESSION TO THE EUROPEAN UNION

1. SWOT ANALYSIS OF ACCESSION TO THE EU

Strengths

The State Union of Serbia and Montenegro falls into the group of countries which, due to their economic and political problems, initiated the process of transition with a delay of more than ten years relative to other economies in transition. Therefore, its economy is still relatively underdeveloped and faced with many problems which are characteristic of the early phases of transition. Despite all this, there are specified strengths in the process of accession to the European Union. As it is stated in the Third Annual Report on the SAP for SEE by the European Commission "For the acceding countries, the accession process has served as a catalyst for change, accelerating the implementation of complex and difficult political, institutional and economic reforms. The conclusion of the process is a significant achievement that was based on sustained commitment over many years to the goal of membership (1).

Specific strengths of SM's accession could be summarized as follows:

1. The fact that **most citizens support accession to the EU as a strategic aim**, which should be achieved as soon as possible, can be regarded as significant strength. The latest survey conducted by the Government of the Republic of Serbia has shown that 84% of citizens supports accession to the EU, 14% is against it and 2% is uncommitted. These data show that support to accession to the EU is extremely high and much higher than that recorded in the group of 10 countries which became EU members this year. All political parties, at least declaratively, agree that accession to the EU is a strategic aim, although no political census has so far been reached as to what should be done to accelerate it.

2. **SM's significant strength lies in its geo-strategic position**, bearing in mind that, at the Thessaloniki Summit, the EU clearly stated that "the Western Balkans and support to their preparation for future integration into European structures and ultimate membership into the Union is a high priority for the EU" (2) (whereas this process is not anticipated for some African countries, primarily the Maghreb ones, which expressed their wish to accede to the EU, as well as for the Asian countries, excluding Turkey). From a territorial viewpoint, the EU will not be rounded off until SM also becomes its member, because the major transport routes run across its territory. This refers especially to the road and rail transport corridor X, which represents the shortest link of Europe with its territorially unconnected members Greece and Cyprus and its future members, especially, Bulgaria and Turkey. "Moreover, Serbia will rely heavily on EU and international assistance, as well as on Danube countries co-operation, in regard to the reconstruction of bridges destroyed by NATO bombing" (3). There is no doubt that, in



addition to an economically compact system, the EU will aspire to a territorially compact system, thus being able to respond efficiently to all global political challenges in the future.

3. SM has a long history of close relations first with the European Economic Community and then with the European Union. The former Yugoslavia was the first socialist country to conclude the Trade Agreement with the EEC as early as 1980 and was maintaining close political relations with it until its disintegration. "After democratic changes, in October 2000, relations between the FRY and the European Union have changed dramatically. Joining the EU became strategic priority of our foreign policy, while in the entire process of reintegration of FRY/Serbia and Montenegro in the international community the EU became our key partner, offering support for political and economic reforms in the country" (4).

A large number of SM citizens working in the EU member countries represent a specific link between SM and the EU. According to the latest data, over 600,000 SM citizens employed in the EU member countries send remittances to their relatives and friends in SM. It is also important to note that the EU is SM's major trading partner (42.15% of total foreign trade).

4. SM has plenty of qualified labor force which worked, in part, under market conditions even in the period of socialism, and not under conditions of a centrally planned economy like other countries of Central and Eastern Europe. Also, in SM small private shops and firms have been operating since 1960s, as contrasted to other socialist countries. Entrepreneurial and managerial culture is rather widespread, so that doing business according to the market principle is not regarded as a new system.

Weaknesses

On its road to the EU, the State Union of Serbia and Montenegro is faced with a great number of challenges, which are primarily related to the elimination of numerous weaknesses.

1. A special problem in Serbia is posed by its **internal political stability**, that is, the fact that not one political party or coalition has a majority in the Serbian Parliament. The previous ruling coalition, DOS (Democratic Opposition of Serbia), was comprised of 17 political parties. It disintegrated after three years, which resulted in early elections last December. The new ruling coalition, which is comprised of four political parties, is a minority one. Support to the formation of its Government was provided by Milošević's Socialist Party of Serbia. After poor political results at the presidential election, the ruling coalition plunged into a crisis and it is highly probable that early parliamentary elections will be staged. In such circumstances, without having a large majority in the Parliament, the ruling parties are oriented primarily toward strengthening their own position, while at the same time avoiding reform-related activities aiming to accession to the EU, which might be associated with any economic and social costs. Coalitions, which are comprised of a large number of political parties, often pursue quite different inter-



ests. Thus, they must often make a compromise, which is not always in the interest of European integration and transition processes.

2. As the result of a political crisis in the early 1990s, the former Yugoslavia collapsed and the two of its republics, Serbia and Montenegro, formed a new state – the Federal Republic of Yugoslavia. Under the non-democratic regime of Slobodan Milošević, the new state was not prosperous. Instead, it soon plunged into a political and economic crisis. With the sanctions and political isolation, the forces in Montenegro, which were in opposition to the Milošević regime and were advocating the separation of Montenegro, were growing increasingly stronger. However, after the fall of the Milošević regime, contrary to the expectations, these forces culminated in their advocacy of the independence of Montenegro. At the same time, the currents advocating the independence of Serbia appeared as well. As the result of such pressures, the state status was changed and the State Union of Serbia and Montenegro was formed as a loose federation, with a number of con-federal elements. The Constitutional Charter provides for the possibility that each republic holds a referendum on its state status after three years.

The disintegration of the State Union would also mean a slowdown in the process of accession to the EU, since the two new states would have to apply once again for membership in all European and world institutions, while the negotiations on accession to the EU would have to start from the beginning. At the same time, there is a sharp division in Montenegro into those who advocate the survival of the State Union and those who do not. One should bear in mind that, due numerous migrations, a great number of the inhabitants of Montenegro lives in Serbia (according to some estimates, there are as many Montenegrins by origin in Serbia as in Montenegro). Bearing in mind that the present Montenegrin leadership aspires to the independence of Montenegro, a breakaway could cause political instability in Montenegro to a significant extent.

3. Due to the mentioned problems in the State Union, **there is no single market or single economic territory**. In part, the reasons should be sought in different economic interests (disproportions in size and, thus, in the economic structure). However, in part, they are also of a political nature. Of the four European freedoms, including the free movement of labor, goods, services and capital, only the movement of labor is free; the movement of goods and services still encounters significant barriers, while the movement of capital is not free at all. Despite the fact that, as of late, attempts have been made to harmonize the economic systems of Serbia and Montenegro, it can be stated that we are still very far from that aim. Almost all major economic laws have been adopted at the republican level and their provisions differ very much in the two republics. The tax system is also different. The tariff system has not been harmonized for 56 agricultural products and there are no joint customs authorities. The two republics also use different currencies: Serbia uses the dinar and Montenegro the euro. The provision of financial services is not free, because the operating license issued in one republic is not valid in the other. It can be stated that, although Serbia and Montenegro are formally in



one state, the degree of mutual harmonization of the economic systems is lower than in EU member countries, which are formally independent states. However, the EU has accepted reality in Serbia and Montenegro and has agreed to the so-called double-track accession to the EU, which actually anticipates a double-track approach in the field of economy, in particular.

4. A special problem is posed by the fact that **there is no adequate administrative capacity** for support to the accession of the State Union to the EU. The office at the level of the State Union, as well as the unit within the Office of the Serbian Vice-Premier do not have a sufficient number of experts, nor do they cover a great number of significant areas. In general, there is a small number of experts in the State Union who are concerned with the issue of accession to the EU and who have necessary knowledge. An adequate approach to be taken is to establish the Ministry of European Integration or/and units for accession to the EU within individual Ministries.

5. Serbia and Montenegro still has no national strategy for accession to the EU, although the work on its preparation began almost nine months ago. This planning document was adopted by almost all countries in transition aspiring to EU membership. Its basic significance lies in the fact that it should determine the future course of action in the process of acceding to the EU.

6. **SM's economic development is at a very low level.** GDP per capita amounts to about USD 2,500 and the country is still far from reaching the level of output prior to the 1990s. In other words, the level of GDP is about one half of that in 1989. In all countries in transition that have become EU members, this level has been exceeded to a considerable extent, except in the Baltic countries.

Although the EU has not stated in public that one of the criteria for accession to the EU is also a specified minimum level of GDP, it is quite clear that not one country will become a full EU member unless it reaches a specified minimum level of GDP. In the opposite, there would be an excessive outflow of funds from the budget of the present EU member countries, so that some of the new EU members might become the net providers of funds. The necessary level can be determined indirectly, on the basis of the level of GDP per capita of the new EU member countries. According to the data from the Transition Report, the lowest level was recorded in Latvia – USD 3,605. The following Table gives a comparative survey of GDP per capita in SM and in the countries in transition which acceded to the EU this year (8).

Table 1. A comparative survey of GDP per capita in USD

Country	GDP per capita
Czech Republic	6742
Estonia	4795



Hungary	6581
Latvia	3605
Lithuania	3988
Poland	4924
Slovakia	4407
Slovenia	11026
SM	2500*

Source: EBRD, «Transition Report», 2003.

* - Economics Institute's estimations

Opportunities

1. Accession to the EU can provide a significant **impetus to accelerated economic development and the creation of new jobs**. The hitherto experience shows that all countries, which had joined the EU, entered the period of a dynamic economic development after a shorter or longer time lag. In that context, the funds that SM would obtain as an underdeveloped country would be of great significance.

2. **Free access to the EU market would provide a great incentive to the development of specified industries**, such as: textile industry, agriculture, food industry, construction industry and engineering, in fact "during the transition, enterprises in SEE have found it difficult to reach markets abroad for several reasons" as recognized in the "Spotlight on south-eastern Europe"(5). Naturally, poses a threat, because a large number of producers will not be able to withstand competition from other producers from the EU. On the other hand, this would facilitate the transfer of technology and know-how, which represent one of the most sensitive issues of SM's economy. Stronger competition would exert influence on domestic producers to speed up their restructuring and increase the efficiency of their production.

3. An opportunity is also provided by the fact that the EU expressed its **readiness to admit all countries in transition (CITs) from South-Eastern Europe** on a number of occasions and that the accession time-limit depends largely on individual countries and the results of their reforms. Insofar as SM is concerned, the process of accession was initiated by adoption of the feasibility study.

4. By acquiring the status of a candidate for accession to the EU, it would be possible to **use significant EU accession funds** (i.e. the CARDS Programme, PHARE Programme and the Instrument for Structural Policies for Pre-Accession) and the Special Accession Programme for Agricultural and Rural Development.

"The EU financial support to the FRY/SMN, in particular within the framework of the CARDS programme for the Western Balkan countries, is particularly important. In the year 2000, the



FRY received 200 million Euros (Serbia 180, Montenegro 20). In 2001, 223 million Euros were disbursed (Serbia 203 Montenegro 20) and 200 million Euros in 2002 (Serbia 180, Montenegro 20). The sum for the year 2003 is 242.5 million Euros (Serbia 229, Montenegro 13.5)” (4).

5. An attenuating circumstance in the process of accession is the fact that eight countries in transition have acceded to the EU and that another three countries (Bulgaria, Romania and Croatia) have the status of a candidate for accession to the EU. By relying on the experience of those countries, which initiated reforms and the process of accession to the EU a long time ago, SM's road will be facilitated to a degree.

6. There is no doubt that SM will not become a EU member in the foreseeable future (depending on the progress of its reforms, the realistic time-limit is 5-8 years). This provides **enough room for a gradual process of harmonization with EU legislation**, coupled with the clearly defined time-limits. This leaves enough time to the economy to get acquainted with the new regulations and enough scope for a gradual restructuring of the government and its economy.

7. After the fall of the Milošević regime (in October 2000), **most macroeconomic indicators were significantly improved**: there are continuously positive growth rates of GDP; the rate of inflation was reduced to a single-digit one; foreign debt was reduced; a significant part of the economy was privatized; great progress was made in the banking reform; there is a steady increase in real wages, etc. According to the level of its economic development, the country has reached some countries candidates for accession to the EU, such as Bulgaria and Romania. As already mentioned, further acceleration of economic growth is a prerequisite (unwritten) without which accession to the EU will not be possible.

8. One of the major results of the hitherto reforms is **macroeconomic stability**. In a more recent and more distant past, economic policy was frequently abused so as to pursue specified interests. Hyperinflation was also recorded at the time of the former Yugoslavia, but it culminated in the world's second highest hyperinflation in 1993. In that context, the process of accession to the EU represents the limiting factor for the abuse of economic policy because, on the one hand, it will be necessary to implement such economic policy as will be oriented towards achieving the designed values of macroeconomic indicators and, on the other, the «external» monitoring of economic policy will be conducted (by the IMF, EU institutions, etc.).

Threats

1. Full membership in the EU would **mean the opening of the domestic market to all EU producers, without any form of protection** or the possibility of implementing protective measures later on, if the balance of payments is aggravated.



Considering the current development level of the SM economy, there is no doubt that a large number of producers will not be able to withstand pressure from competition and will probably go bankrupt, thus causing the problems related to a rise in unemployment.

Therefore, the acceleration of economic restructuring, as well as the finding of strategic partners for those enterprises, which cannot be rehabilitated so as to approach the market autonomously and successfully, impose themselves as a matter of urgency.

2. A threat that the accession process might be slowed down is also posed by specified **populist pressures from the groups** whose position could be endangered by this process, which refers primarily to economic and social demands and protests to which no government can be immune, and from the groups that might lose their jobs. There are also pressures from monopolists, who would lose their dominant position with accession to the EU.

3. A potential threat may also be posed by the **demands within the EU for stiffening the accession criteria for new members**. Throughout its history, the EU has never been faced with such an enlargement. It is uncertain how this enlargement will affect «old» and «new» EU members. “For the newcomers obviously a more critical situation may occur in their catching up process, where a moderate slow down has already started. Not to talk of the 2007-2012 policy challenges and budgetary means of the European Union. And these will be the years in which other partners are in the pipe for membership” (6).

In the case of a more significant deterioration of the budget situation, the accession criteria will certainly be stiffened or, in other words, it will be requested that the admission of new members should be postponed. If all countries, which have expressed their readiness to become EU members, accede to the EU, it is certain that most of the new EU members will become the net providers of funds, thus making their membership meaningless in large measure.

4. **Kosovo's unsettled status complicates significantly the problem of accession to the EU**. Kosovo is formally a part of SM, but the government bodies have no jurisdiction over its territory and population. The process of its accession is following a separate course, in view of the fact that the feasibility study covers the State Union without the territory of Kosovo, which is considerably lagging as regards economic development, reforms and respect for human rights.

This means that at one moment the question of accession to the EU or renouncement of Kosovo might be raised if Kosovo's final status is not settled before SM's accession to the EU. Such a trade-off could only contribute to internal political instability still further. Therefore, it is clear that one must aim to solve this delicate question (Kosovo's final status) prior to accession to the EU.



The EU gives its full support to the implementation of Resolution 1244 of the UN Security Council on Kosovo and of the “standards before status” policy but it recognizes that ethnically motivated violence in March 2004 represented a major setback in the stabilization of the security situation across the region and that “the inadequate security continues to be a major obstacle to returns”(1) as well as that “ethnically motivated threats, violence and destruction of property are not compatible with European values and standards” (1).

5. Cooperation with the Hague Tribunal and membership in the Partnership for Peace

have also been set as the requirements for accession to the EU. It was concluded at the Thessaloniki Summit that “the EU urges all concerned countries and parties to co-operate fully with the International Criminal Tribunal for the former Yugoslavia.

Recalling that respect for international law is an essential element of the SAP, the EU reiterates that full co-operation with ICTY, in particular with regard to the transfer to the Hague of all indictees and full access to documents and witnesses, is vital for further movement towards the EU” (2). Although Serbia has significantly improved its cooperation with the Hague Tribunal, there are still a considerable number of persons whose extradition is requested and who are assumed to be in the Serbian territory.

Membership in the Partnership for Peace is not explicitly mentioned as a prerequisite for accession to the EU, but one should bear in mind that all countries that have acceded to the EU are members of the NATO or Partnership for Peace. The conditions for SM's accession to Partnership for Peace are linked to cooperation with the Hague Tribunal.

STRENGTHS	WEAKNESSES
Most citizens support accession to the EU	Internal political instability, which is slowing down reforms and transition processes
Favourable geostrategic position	Uncertain status of the State Union
Long-time, close economic and other relations with the EU	Difficulties concerning the harmonization of the internal economic systems of Serbia and Montenegro
Qualified labour force and entrepreneurial culture	Inadequate administrative capacity for accession to the EU
	Non-existence of the national EU accession strategy
	Low level of economic development
OPPORTUNITIES	THREATS
Faster economic growth and the creation of new jobs	Competitive pressure from producers from the EU market
Free access to the EU market	Populist pressures, which are slowing down



	accession to the EU
EU's readiness to admit CITs from South-Eastern Europe to EU membership	Requests within the EU for the stiffening of the membership criteria
Initiated process of accession, including the possibility of using EU accession funds later on.	Uncertainty about Kosovo's final status
Use of the positive experiences of other CITs	Political factors (conditioning entry into the Partnership for Peace and NATO)
Gradual harmonization with the EU regulations	
Continuous improvement of the macroeconomic indicators and economic performance	
Maintenance of macroeconomic stability	

2. THE STRATEGIC OBJECTIVES OF THE FORTHCOMING ECONOMIC DEVELOPMENT

2.1. The Acceleration of Reforms and Transition Processes

The favorable conditions for the acceleration of reforms and transition processes in Serbia were provided only after radical political changes in the October 2000. At the moment of coming to power, the new democratic Government was faced with two, equally serious problems. On the one hand, citizens had high expectations regarding rapid increase of their standard of living after the real economic and social collapse as the result of ten-year long isolation, breakdown of the former Yugoslav market, armed conflicts in the surroundings and NATO bombing of the country in 1999. On the other hand, it was necessary to accelerate reforms to a maximum, thus making up, at least to a degree, for a ten-year delay in transition processes, as compared to other countries of Central and Eastern Europe. "Due to conflicts of the last decade, the development of the functioning market economies in this region is more demanding and will take longer than did transition in Central Europe" is stated about Western Balkans in the Third Annual Report of the European Commission(1) and although the international community acknowledges the gravity of the situation much effort was put in overcoming these obstacles and there are yet many issues to be addressed.

The first generation of reforms, especially in 2001–2002, was carried out "by the book". "Initial phase reforms include price and trade liberalization as well as small-scale privatization. They are more straight-forward to implement in the sense that they primarily require a reduction in state activity while the second, more difficult, phase of transition focuses on the development of market-based structures and institutions" (5).

The first phase of reforms in SM produced mostly favorable results:



- Macroeconomic stability was achieved (the inflation rate was reduced to a single-digit one;¹ the internal convertibility of domestic currency was introduced, while the budget deficit of 2–5% of GDP was financed exclusively from the real sources), coupled with an adequate rate of economic growth of 4–5% per annum.
- Foreign economic relations were liberalized (foreign trade restrictions were lifted; average tariff rates were lowered below 10%; a number of foreign trade agreements was signed with Russia, former Yugoslav republics and the countries in the region).
- In 2002–2003, the new privatization model brought €1.2 billion into the state budget, contracted investments valued at €720 million and €270 million for social programs. During that period, over 1,000 enterprises were privatized.
- A greater number of important reform-related laws was adopted in the fiscal, monetary and banking sectors, as well as in the areas of foreign economic relations, labor market, capital market, legal system and social insurance.

However, these initial successful results blurred and concealed numerous problems which, especially in 2003, were becoming increasingly more evident and, finally, caused a delay in, and the blockade of the further reform processes.

It turned out that the political elite failed to reach a consensus on the second generation of reforms (as was done by successful countries in transition) which, above all, refer to the rounding-off and functioning of the institutions of a market economy and the rule of law in full, thus affecting the results achieved in the first phase of reforms.

The first problem lies in the fact that the basic market institutions – the protection of property and contract, labor market and capital market – did not start to function in full. Banking and financial reforms stopped halfway. The judiciary is still functioning according to the old principles. The grey economy has not been reduced. The reform of public administration has not yet started more seriously. Corruption has been intensified, “among the 26 transition countries in the BEEPS, the problem of bribing public officials is worst in Bosnia and Herzegovina, FYR Macedonia, Serbia and Montenegro” (5). Organized crime has penetrated all spheres of economic and political life which, at the beginning of 2003, culminated in the assassination of the Prime Minister.

The second problem was reflected in the increasing fear of the employed and a great number of citizens that the heaviest burden of reforms would be shifted to the population at large, including dismissal from work and poor prospects for the young generation – and that they were the major losers in the first phase of transition. The relevant studies show that in Serbia there are currently about 1,600,000 poor people or 20%. “Poverty mostly affects socially vulnerable groups (children, the elderly, persons with disabilities, refugees and internally displaced per-

¹ In 2004 and 2005, however, the inflation rate increased and became a two-digit one again, i.e. 13-15%.



sons, Roma, the rural population and uneducated people)" (7). On the other hand, an impression has been created that the major winner of the first phase of transition is the small elite, formed during the period of sanctions and the previous regime, which is now trying to extend its dominant economic position to all spheres of life, coupled with the (repeated) establishment of close links with the repositories of power. This narrows the scope for the new young class of entrepreneurs to assume leading positions in the economy and increase economic activity, create new jobs and link Serbia faster with the rest of the world, led by the profit motive, under conditions of competition and government support.

All things considered, it can be said that the reform-oriented, pro-European and market orientation of Serbia has not yet been unconditionally accepted. Many of them hold that this process will last too long and that the price to take reflected in the low standard of living and a high rate of unemployment will be too high. Thus, they are prone to the populist solutions, i.e. faster, short-term improvements in the living conditions regardless of the subsequent negative consequences (high inflation, loss of interest on the part of foreign investors, increase in the country's debt and further social segregation). In short, a definite breakaway with the past (in an economic and political sense, including a change in the frame of mind linked to the old system) has not yet been made.

Therefore, the acceleration of reforms and transition processes in Serbia must be in the service of lasting political stability and clear market, reform and pro-Europe orientation, which requires:

- Full political consensus on the key issues relating to accession to the EU;
- Establishment of an institutional framework for the implementation of the rule of law and the international standards and code of conduct;
- Adoption of the remaining reform laws and their efficient implementation, thus creating an attractive business environment for foreign and domestic investors.

Full political consensus on the key issues relating to accession to the EU will be reached by:

- Adoption of the Resolution on Accession to the EU by the Parliament;
- Urgent adoption of the National Strategy for Accession to the EU;
- Making up the exact "timetable" (phases) in the process of accession to the EU.

The establishment of an institutional framework for the functioning of the rule of law, international standards and code of conduct implies:

- Fight against economic crimes, corruption, grey economy and all types of rent-seeking behavior;
- Stimulating competition and equal treatment of all market participants;
- In the second phase of transition new domestic and foreign investors should, together with the already privatized, successful enterprises, generate future growth, exports and new employment (the major winners);



- Implementation of the government social program (implementation of the Poverty Reduction Strategy) so as to dispel the fear of a great number of inhabitants who, due to a rise in unemployment and poverty, feel like being the major “losers” in transition (out of 7.5 million inhabitants in Serbia, 1.6 million are considered to be poor);
- The prevention of “populist” policy, which seeks support from citizens who are afraid of reforms, as well as from those sectors of the economy which hope for the country’s economic isolation and maintenance of their monopoly and rent-seeking position.

The adoption of the key reform laws and their efficient implementation, thus creating an attractive business environment for investors:

- The Law on VAT – in force from January, 1 2005;
- The lowering of the corporate income tax to only 10% (the lowest in Europe) – it was adopted in July 2004;
- The Bankruptcy Law – it was adopted in July 2004;
- The Law on Executive Procedure (with short time-limits for execution and a greater number of judges);
- The Anti-monopoly Law;
- The Law on Investment Funds;
- The Law on Enterprises;
- The Denationalization Law;
- The new Law on the Securities Market;
- The solutions stimulating the legalization of the grey economy (e.g. by lowering taxes and contributions levied on newly registered workers);
- Efficient implementation of the Law on Enterprise Registration (one-stop shop).

2.2. Development through European Integration and Development Processes

A vital prerequisite for accession to the family of European countries is a successful process of transition or, in other words, the implementation of market reforms in the economy, democratization of society and the establishment of the rule of law. Those are the basic conditions which must be fulfilled before embarking on the long road to accession to the EU.

The enlargement of the European Union has long been the subject of a debate, both in terms of selection of an appropriate scenario and in terms of the assessment of the positive and negative effects of accession of new countries on the EU itself, as well as on the countries joining European integration processes.

The assessment of the positive and negative effects of accession to the EU is of utmost significance for all candidate countries, because the cost-benefit analysis provides a basis for the identification of sensitive sectors which are of great national interest to candidate countries and on which it is especially insisted during the accession negotiations with the EU. Those are



the duration of the transition period required for the harmonization of domestic legislation and practice in these sensitive sectors with the needs of the EU. It is also expected that this analysis will point to all advantages and disadvantages of EU membership, thus providing a clearer and more realistic picture about all possible effects that will be generated upon the candidate country's accession to the Union.

In most cases, numerous hitherto analyses of the accession effects on the candidate countries have arrived at the conclusion that the potential benefits exceed the integration costs to a considerable extent. These multiple benefits include the enlargement of the market by about 500 million inhabitants; greater investment security; creation of new jobs; accelerated growth; technological development; strengthening of peace and security within the EU, etc. However, one should not disregard the obligations assumed by new EU member countries, especially financial ones, which are certainly not neglectable.

Table 2. **Changes in the level of GDP per capita EU=100**

Country and the year of accession to the EU	1973	1981	1986	1990	1995	1998	2001
Ireland (1973)	59	65	64	74	96	108	134
Spain (1986)	75	70	70	77	79	81	98
Greece (1981)	71	69	63	58	66	68	87
Portugal (1986)	58	56	54	61	71	72	84

Source: Stojan Stamenković et al., A Contribution to the Study »A Contribution to the Preparation of Serbia's Strategy for the FRY's Accession to the EU«, Ministry for International Economic Relations, Belgrade, 2002; European Economy, 73/2001; World Bank Atlas 2002.

The effects of accession to the European Union on economic growth and development can be illustrated in the best way if one points to the experiences of Ireland, Greece, Spain and Portugal which, after their accession to the EU, succeeded in providing an impetus to their economic growth. In confirmation of the macroeconomic effects of accession, one can use the data on changes in the level of GDP per capita of these countries after their accession to the EU (9).

On the basis of these data it can be concluded that in the case of Ireland the process of approaching the EU average was rather slow in the first phase. It was accelerated as late as the mid-1990, two decades after the country's accession to the EU. Spain and Portugal were approaching the EU average income mostly continuously. All countries recorded an increase in the level of investment after their integration thanks to the lessening of a political risk, economic restructuring, response of economic agents to changes in the production and trade potentials, as well as the implementation of new technologies.

Consequently, the effect of EU membership on a country's economic growth is not generated automatically. Also, it is not felt in all countries acceding the EU at the same time. Although their integration into the large common market increases competition and the efficiency of



economic agents, all differences among countries are not eliminated. Long-term economic growth depends primarily on the initial conditions; rate of increase of physical capital, that is, the share of investment in GDP; rate of increase of human capital, and the overall social and political climate. The closing of an income gap between EU member countries and countries candidates for membership in the EU depends not only on the rate of growth, but also on the ability of a country's economy to maintain those rates of growth over a longer period of time.

The positive effects of accession to the EU can also be expected with respect to the restructuring and the spatial and sectoral reallocation of the candidate country's productive resources. By acceding to the EU, the national economy becomes integrated in a single market, with the free movement of goods, services, capital and people, which contributes to the equalization of the prices of goods and other factors of production, as well as to the removal of price disparities. For its part, stronger competition forces domestic producers to increase their productivity, take advantage of economies of scale and make optimal use of the factors of production. This naturally results in higher business efficiency, which is one of the major positive effects.

The process of European integration also creates favourable conditions for a higher capital flow into the domestic economy in the form of direct investment or much better potentials for the use of special-purpose Funds within the EU, which contributes to accelerated growth, technological and other forms of modernization of the national economy in the medium and, in particular, long run. After their accession to the EU, in all less developed countries (except Greece) the share of foreign direct investment in GDP increased considerably, thus generating a very favourable effect on economic growth.

A positive effect is also expected in the area of services trade and capital flows. The liberalization of services and capital flows within the EU brings about a decrease in prices, especially in the prices of financial services, the lowering of interest rates and profit margins, prices of telecommunications, air transport, road transport of goods, etc. It is estimated that a decrease in the prices of financial services by over 10% has a long-term effect on the growth of GDP by about 1.5%.

As for foreign trade, the positive effects of accession to the EU are reflected in its increased volume and, in particular, the improved pattern of exports and imports. The agreement to be concluded by a candidate country with the EU provides for a gradual lowering of tariff rates on specified groups of products, thus avoiding all potential shocks that some producers may experience due to trade liberalization and the removal of trade barriers after the country's accession to the EU. In this regard, the case of Slovenia is impressive: by the end of 2001, it lowered the average nominal tariff rate to 4% and the average effective tariff barrier to about 6%, in addition to lifting quantitative restrictions almost completely. An important issue is also the need to consider non-tariff barriers for the protection of the domestic economy, thus enabling



a gradual and »painless« integration into the EU, as well as preparations for joining the WTO. It is important to adopt such a concept of non-tariff barriers that will rely primarily on the export-oriented development aims, thus avoiding mistakes made by Greece in its process of accession to the EU. Namely, in the initial phase of accession, Greece lowered its tariff barriers to a considerable extent and even removed them in some cases. At the same time, it increased export subsidies and non-tariff barriers. After its accession to the EU, export subsidies and certain non-tariff barriers were removed. This resulted in an enormous increase in imports, while exports remained at the same level. At the same time, there was a dramatic increase in the trade deficit.

The assessment of the positive and negative effects on individual sectors of the economy is very complex. In addition, it requires the development of an input-output model. The experiences and calculations of other countries cannot be used to predict the effects in the case of Serbia and Montenegro due to differences in the economic structures, development levels and other specifics of their economies. However, some conclusions can still be derived. Those sectors, which were export-oriented and exposed to competition before the country's accession to the EU, will not encounter greater difficulties because, as a rule, they adjust easily. On the other hand, those sectors which enjoyed high government's protection before the country's accession to the EU (such sectors most frequently include agribusiness, construction industry, transport and insurance) must, timely and without greater shocks, make much greater efforts to adjust and become more efficient and more competitive.

By joining the single European market, the country derives benefits from the removal of physical, fiscal and technical obstacles at the borders within the Union, thus drastically reducing or even eliminating the costs associated with customs control, other cross-border administrative formalities, costs of keeping goods at the border, costs of obtaining certificates of origin, etc. This generates a favourable effect on export-oriented companies, in particular.

European integration also generates very significant, positive net budget effects, especially in the initial period of accession to the EU. In fact, the EU budget serves mostly to alleviate the problems and eliminate the unfavourable effects of accession, regardless of whether it is the question of a country, a region, an economic sector or a social group. In this regard, the major role is played by the Common Agricultural Policy, Structural Policy and Regional Fund, which account for about 80% of the EU's total budget. Despite the expenses associated with member countries' contributions to the EU budget, it has been concluded that the amount of assistance exceeds the expenses to a considerable extent. Positive effects on the budget may also be generated by the liberalization of public procurement because, instead of more expensive domestic equipment, it enables the imports of cheaper equipment and vice versa.

The Balkan countries are in the position to prepare themselves faster for accession to the EU through mutual economic integration within the Stability Pact. Through integration processes



all Balkan countries can ensure stabilization, security, democratization and economic development and, on these grounds, cultural and economic approachment to the EU. In addition, the Balkan countries would be able to settle the inherited political conflicts and satisfy the political criteria for accession to the EU. Apart from political stability and security, the positive effects would also consist of the following:

- The region so integrated would acquire a much greater negotiating power and receive specified concessions in which individual countries would not succeed;
- Intra–industry trade would be strengthened;
- The traditional advantages of a larger market would also become evident, i.e. the division of labour and a higher degree of specialization. The resources, especially human capital, would be used much more efficiently. The enlarged market also enables the use of all favourable effects of economies of scale;
- This would result in the strengthening of competition, as well as in higher efficiency and economic growth, thus generating a favourable effect on public welfare.



II THE FIRST PHASE OF ACCESSION TO THE EU

1. THE PROCESS OF HARMONIZATION AND MEASURES WITHIN THE FIRST PHASE OF ACCESSION TO THE EU

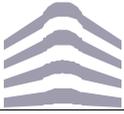
1.1. Description of EU Legislation Regulating the Selected Areas

At its meeting held in Copenhagen, in 1993, the Council of Europe set the economic and political criteria which all countries candidates for accession to the EU should meet so as to become full members of the EU. Those are:

- The stability of institutions which guarantee democracy, rule of law, human rights and respect for, and protection of the minority rights;
- The existence of a functional market economy and its ability to face pressures from competition and market relations within the EU;
- Readiness to assume the obligations arising from membership, including the aims of a political, economic and monetary union, which is reflected in the implementation of the *Acquis Communautaire* and the possibility to apply it effectively to the system of government administration and judiciary.

To achieve the last aim of the Copenhagen criteria, it is necessary to adopt special, so-called Community regulations and harmonize national regulations with the Community legal system, that is, to conduct the harmonization process. Harmonization implies the adjustment of national regulations with the regulations of Community law contained, above all, in the Community directives, to the extent being necessary for the achievement of the Community aims. The aim of harmonization is not unification, that is, the adoption of unique solutions with supranational validity for all member countries. Rather, its aim is to harmonize different solutions embodied in national legislation. Therefore, in EU member countries there are two kinds of national regulations which exist parallel with the Community ones: the first arise from the implementation of community regulations and have been harmonized by member countries, while the second are national ones which regulate those areas whose harmonization is of no relevance to the achievement of the common aims.

However, harmonization is not the aim in itself; rather, it serves as a means of achieving the narrower legal-technical and broader political aims. From a legal-technical viewpoint, the aim of harmonization is the adoption of new regulations and the harmonization of existing ones with EU regulations. However, the aim of harmonization does not stop at the adoption of domestic regulations harmonized with Community law; it is also necessary to create social and economic conditions for the implementation of regulations, thus enabling the achievement of those aims which are compatible with the Community ones. The relevant activities must not be confined to the activities of legislative bodies. They must also concentrate on the development



of relevant infrastructure: professional and independent judiciary and an efficient state based on the rule of law. Therefore, harmonization is not confined to the mere copying of community regulations. It consists in the adoption of such regulations whose consistent implementation will contribute to the achievement of the aims being complementary with the Community ones.

The obligation to harmonize their legislations has been assumed by EU member countries by signing the Treaty establishing the European Union, while third, non-member countries do not have this obligation until making institutional arrangements with the EU or, in other words, before concluding specified agreements² with the European Union. For non-member countries, the harmonization of national legislation with EU regulations forms part of the pre-accession strategy for the establishment of the closest possible relations with the EU, the ultimate aim being full membership. However, harmonization does not have to be carried out only in the context of the pre-accession strategy because, even if institutional arrangements with the EU are not made, most countries harmonize their internal regulations so as to be integrated into the general process of globalization of law.

In order to promote and accelerate the process of harmonization with Community law, the European Union offered to third countries of Central and Eastern Europe a special »recipe« for harmonization with the so-called White Paper. By means of the White Paper, the countries wishing to join European integration are recommended to harmonize their regulations with EU ones in 23 areas. Later on, the White Paper was expanded to cover 31 areas. The presented process of harmonization is concerned primarily with economic regulations or, in other words, it focuses its attention on securing four fundamental freedoms, including the free movement of goods, services, capital and labour. Consequently, it is not insisted on the harmonization of all regulations, but only of those which will enable the achievement of the aims being common to, or compatible with the aims of the European Union. It is recommended that the harmonization process should be conducted in several phases, the duration of which will depend primarily on existing legal, economic and social infrastructure. The process should consist of the following phases:

- Identification of the areas of European law, as well as those with which national legislation should be harmonized;
- Preparation of the list of the corresponding domestic regulations;
- Determination of compatibility between the Community regulations and the corresponding domestic regulations;
- Identification of the competent legislative bodies for the adoption of new, or modification of existing domestic laws for which it has been established that they are not in conformity with Community law;
- Formulation of the harmonized domestic regulations.

² It is the question of the agreements under which the European Union recognizes the status of a candidate or potential candidate for full membership in the EU to third countries.



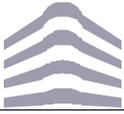
The current phase in the relationship between Serbia and Montenegro is characterized by the non-existence of the legal obligation to harmonize domestic regulations with EU legislation, since no institutional arrangement has so far been made with the EU. This relationship is also characterized by the voluntariness, that is, freedom of the competent bodies, as well as the limitation of harmonization to specified measures and activities. However, bearing in mind the country's orientation to accelerated inclusion in European integration processes, it can be expected that the procedure of voluntary harmonization of domestic legislation with EU legislation will begin. The voluntary character of this process enables the country in the transitional phase of harmonization to select the priority areas for harmonization with Community law. When this becomes a contractual obligation (after the conclusion of the Stabilization and Association Agreement), Serbia and Montenegro will be able to take advantage of the single European market by discharging its contractual obligations.

In further text we will provide a short survey of EU legislation governing the areas that will be analyzed elsewhere in this Study and will have to be adopted in the process of harmonization, the efficiency of which must be ensured. We point out that this is the survey of EU legislation which should be adopted, or with which domestic regulations must be harmonized in the first phase of harmonization.

1.1.1. EU Legislation Regulating the Free Movement of Goods

Since the adoption of the idea about the creation of a single market within the European Union, it has been clear that all tariff and non-tariff barriers between EU member countries should be removed, thus enabling the free movement of goods. Therefore, the Treaty establishing the EU, other European Agreements, as well as the Stabilization and Association Agreement provide for the removal of tariffs, quantitative restrictions on imports and exports, as well as other measures having an equivalent effect. In addition to the mentioned agreements, this issues are indirectly regulated by, and related to competition policy (with respect to state monopolies, government assistance and granting of exclusive rights by the government) and tax policy (as regards different tax treatment of domestic products and products from other EU member countries), which are the subject of a special analysis in this Study.

In the 1980s, since the provisions of the Treaty establishing the European Union do not define explicitly the concept of goods in question and what the trade barrier is, while at the same time attempting to surmount the obstacles arising from different national regulations, the principle of mutual recognition of legislations was adopted. According to this principle, products that have been legally produced and/or sold in one member country must be allowed to move freely in other EU member countries, regardless of whether this is in conformity with the regulations of those member countries. In the areas where there are great differences between legislations, the regulations have been harmonized. EU accession candidate countries are obliged to gradually establish a free trade area with the EU, in accordance with the provisions of the



Treaty establishing the European Union, GATT and the Agreement establishing the World Trade Organization. In the first phase of accession to the EU, these countries are required:

- To adopt and apply the Combined Nomenclature for the classification of goods in mutual grade;
- To gradually reduce tariffs and abolish all measures having an equivalent effect, and
- To abolish all quantitative restrictions and measures having an equivalent effect.

1.1.2. EU Legislation Regulating the Free Movement of Capital

The liberalization of capital flows is one of the major preconditions for the opening of the internal market and accession to the EU. Therefore, in the first phase of harmonization with EU legislation and practice, it is necessary to liberalize all long-term and medium-term movements of capital and current foreign exchange transactions which, in turn, contributes to the attraction of foreign capital, integration into the global economy and faster development of the financial sector in the country carrying out liberalization.

EU legislation regulating the free movement of capital is based on the following principles:

- No difference is made as to the source or purpose of capital;
- Capital transactions are freed from control and foreign exchange restrictions, while the rights to such free transactions are conferred to residents and not to citizens;
- Exemptions from these freedoms are possible only if there is a threat to national security or the public interest.

In order to implement legislation regulating the movement of capital in practice, it is necessary to provide specified preconditions, such as: the creation of a clear legal basis for foreign investment (especially with respect to the provision of investment guarantee), incentive tax regulations, efficient and open financial market, and well-developed instruments of monetary policy.

The measures within the first phase of accession to the EU include the liberalization of current payments, and medium-term and long-term capital flows, thus ensuring the linkages with international capital markets and creating conditions for the inflow of capital. Under the Directives of 1960, 1963 and 1986, EU member countries harmonized the procedure for liberalization of all forms of medium-term and long-term capital flows among themselves. With the liberalization of all capital flows on 24 June 1988, the mentioned Directives were abolished and replaced by Council Directive 88/361/EEC.

1.1.3. EU Legislation Regulating Competition Policy

The efficient functioning of the single market in the territory of 25 European countries cannot be efficient, without establishing the system that will eliminate all disruptions of competition on that market. For this reason, the adoption of competition policy and its efficient implementation



are a vital prerequisite for the opening of the internal market and, over time, joining European integration.

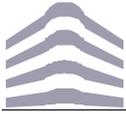
Competition policy, implemented within the European Union, is based on the regulation of state monopolies and operations of public enterprises, control of the amount of government assistance, control of concentration, as well as the control of restrictive agreements and sanctioning of the abuse of a dominant market position.

State monopolies, public enterprises and enterprises with special and exclusive rights pose a threat to competition policy, thus being subject to special regulations. As for this part of competition policy, EU accession candidate countries are required to implement the following measures in the first phase of accession:

- In those sectors in which there is no aim of common concern, which would justify the existence of specified restrictive agreements or rights, it is necessary to ensure that the competition rules are also applied to public enterprises;
- Identification of the tasks of the public services entrusted to specified enterprises (special or exclusive rights conferred to these enterprises);
- In those sectors in which there is a network of vertically integrated enterprises (like those operating in the electricity, gas, telecommunications and other sectors), it is necessary to make a distinction between different activities (production, transmission, etc.) in their accounting;
- A gradual adjustment of state monopolies of a commercial character, so that EU citizens are not discriminated.

The control and regulation of government assistance are stipulated by Articles 87–89 of the Treaty establishing the European Union. However, due to its extreme importance, this issue has also been embodied in all other European Agreements and the Stabilization and Association Agreements concluded by EU accession candidate countries with the EU. Although in EU legislation there is no strict definition of the term »government assistance«, it is used to imply any assistance which is granted by the government, or through government funds in any form which is affecting, or is threatening to affect competition by favouring specified enterprises, or the production of specified goods, and which may influence trade between member countries. Although it is based on the principle that any government assistance that influences competition is forbidden, the system still permits assistance in specified cases.

Within the scope of harmonization with the EU rules regulating government assistance, countries candidates for accession to the EU are obliged to implement the following measures in the first accession phase:



- To set up a special body that will perform control and supervision over the system of government assistance;
- To adopt a special law that will regulate government assistance uniformly;
- To prepare a detailed list of government assistance programmes, which were adopted prior to the formation of a supervisory body, and adjust them to the EU criteria within a specified period of time;
- To provide for the submission of annual reports to the European Commission, on a regular basis, about all government assistance schemes, based on the EU methodology.

Every integration bears the danger of the creation of uncompetitive market structures, that is, of concentration of power. The relevant EU regulations regard such integration as an unlawful concentration of power, which creates or strengthens a dominant market position, which results in the disruption of efficient competition on the common market or one part thereof to a significant extent. Therefore, in the first phase of harmonization, candidate countries are required to adopt the key elements of the concentration control system as specified by Regulation 4064/89 (EEC). This Regulation defines in more detail the criteria and the notion of concentration control, as well as the relevant procedure.

In order to control restrictive agreements and sanction the abuse of a dominant market position, EU accession candidate countries are recommended to harmonize, in the first phase, their legislations with the key elements specified in Item 1 of the Treaty establishing the European Union, including the exemption principles, thus creating conditions for the establishment of the system of competition. At the same time, it is necessary to conduct the liberalization process and implement all measures aimed at introducing a market economy.

1.1.4. EU Legislation Regulating Direct and Indirect Taxation

Tax policy is also one of the instruments for spurring the development of the single EU market. The relevant harmonization measures are aimed at ensuring administrative cooperation between national tax authorities, and removal of obstacles to cross-border activities of economic agents. The issue of harmonization of tax systems has been embodied in the Treaty establishing the European Union. So, its Article 90 explicitly forbids any tax discrimination that may give priority, either directly or indirectly, to national products over products from other member countries. However, despite the importance of harmonizing member countries' fiscal systems for the purpose of the efficient functioning of the EU internal market, and in view of the fact that tax policy represents the symbol of national sovereignty and one of the essential elements of the country's economic policy, the procedure relating to the harmonization of the tax systems was initiated very cautiously. At the same time, the equalization of fiscal methods and



fiscal policies between EU member countries, as well as by EU accession candidate countries is still underway.

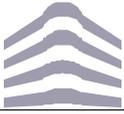
European legislation regards the corporate income tax, capital duty and personal income tax as direct tax forms. Harmonization in the area of direct taxation, at the level of EU member countries, is still modest. EU member countries are left to regulate the income tax by themselves, while at the same time taking care not to endanger the fundamental principles of the common market. More significant results have been achieved in the harmonization of the profit tax and capital duty. In order to harmonize their regulations with EU ones, EU accession candidate countries are recommended to incorporate into their regulations – within the scope of the measures of the first phase – the provisions of Directive 77/799 on mutual assistance in direct and indirect taxation, and Directive 69/335 on capital duty. Reference is also made to two recommendations relating to direct taxation, i.e the taxation of specified non-residents' income (Recommendation 94/79/EC) and the taxation of small and medium-sized enterprises (Recommendation 94/390/EC).

The legal framework for indirect taxation is provided primarily by harmonized legislation relating to the value-added tax (in further text: VAT) and excise taxes. VAT was introduced into the European Economic Community in 1970, under the First and Second Directives, and this tax form replaced the hitherto taxes on production and consumption. The basic part of EU legislation governing this area is Sixth Directive 77/38/EEC on VAT which, in the meantime, was amended a few times. The Directive provides the most important definitions and principles relating to value-added tax, while at the same time leaving to EU member countries a specified degree of freedom.

In the first phase of harmonization with EU legislation, the steps to be taken include the adoption of legal regulations which are of significance for the smooth functioning of the system of value-added tax. In other words, this implies the adoption of the law regulating exclusively the value-added tax, in addition to other laws that may be of significance (e.g. in the areas of trade law, contract law, penal law, as well as the appropriate accounting rules and principles).

The Community's system of excise taxes was established on 1 January 1993 with a view to creating the internal market. EU member countries have the right to retain existing excise taxes, or impose such taxes on other products, provided that cross-border trade in those products does not require special customs formalities and that this is in conformity with the Treaty.

The harmonization of EU member countries' national legislations relating to excise taxes was not gradual. Thus, the Community's excise tax law comprises a set of directives which, except the one on cigarettes, were adopted in 1992. These directives define the movement and supervision of excise products, harmonization of the excise tax structure and equalization of ex-



cise tax rates. In the first phase of harmonization, EU accession candidate countries are obliged to implement the measures aimed at:

- Establishing the warehouse system and
- Imposing the tax on products liable to the Community's excise tax.

1.1.5. EU Legislation Regulating Financial Services

A well-developed financial system enables an efficient allocation of financial resources to the most productive investments, coupled with risk diversification, transfer and trading; thus, the financial system provides a basis for the functioning of a market economy and its long-term development. The foundation of every market economy and successful transformation of a centrally planned economy into a market economy, is a well-developed financial sector. Also, long-term economic development is not possible without an efficient financial services sector.

Since all founding countries of the EU had relatively well-developed financial systems at the time of its formation, the basic task of coordinating their financial sectors was not the development of an absolutely new financial system, but the improvement of the national financial systems by harmonizing the minimum requirements for specified financial institutions so as to establish the minimum common standards, thus contributing to the development of a single financial services market. Bearing in mind that financial services in the ex-socialist countries were based on different foundations relative to those in market economies, they now have to meet the minimum requirements so as to reduce considerable global differences in the structure, functioning and supervision of the financial services sector.

Due to different development levels of the banking sector among the EU member countries, and especially among EU accession candidate countries, at the EU level and within the framework of further integration, the first-phase measures of banking sector development were adopted and embodied in the following EU Directives:

- First Directive 77/780/EEC on banking is concerned with the freedom to establish and provide banking services. It regulates the procedure relating to the submission of applications for the formation and operation of credit institutions, including the minimum amount of own funds, necessary personnel for the management of credit institutions, required reputation and experience, etc.;
- Directive 89/299/EEC on own funds defines the elements of the capital of credit institutions; specifies the structure of the original and additional capital in these institutions, as well as the ratio between these types of capital;
- Directive 89/647/EEC on solvency has, as its basic aim, the harmonization of supervision over the operations of credit institutions, as well as the strengthening of the standards concerning the solvency of credit institutions within the EU.



- Directive 94/19/EC on deposit guarantee introduces the compulsory guarantee scheme into the sector of credit institutions. Its major role is to build depositors' confidence in the activities of credit institutions. The minimum guaranteed deposit is €20,000.

The first three Directives were subsequently amended, consolidated and replaced by Directive 2000/12/EC which sets the minimum requirements for the formation and operation of credit institutions in a consistent way.

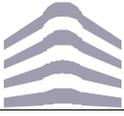
In order to harmonize the method of functioning of the capital market within the EU, member countries and EU accession member countries must observe the following regulations:

- Directive 89/298/EEC on the prospectus is concerned with the coordination of the activities relating to the preparation, consideration and distribution of the prospectus, the most important document for the openness of enterprises whose securities are traded on the market to the public;
- Directive 79/279/EEC on obtaining a listing on the stock exchange sets the requirements which a security must meet so as to be placed on the listing of the stock exchange and be quoted on the market;
- Directive 88/762/EEC on reporting majority shareholding stipulates that the enterprise must notify the public whenever the voting right of a person declines or exceeds the limit of 0%, 20%, 33%, 50% or 66%;
- Directive 89/592/EEC on internal rules is concerned with dealing in securities with connected enterprises, i.e. the use of so-called insider information.

These four Directives have been combined into Directive 2001/34/EC, while on 12 April 2003, the Directive on internal rules was replaced by Directive 2003/6/EC.

When the capital market reaches a specified level of development, new financial market participants are institutional investors. Their operations at the EU level are also regulated by Community rules, i.e. the Directive on Undertakings for Collective Investment in Transferable Securities (UCITS, 85/611/EEC), the provisions of which other EU accession candidate countries also attempt to adopt. The Directive lays down the basic principles for the formation of investment funds; rules on the sale and purchase of their units; investment rules for investment funds; formation of the bodies authorized to issue operating licences, monitor and control these funds, etc. (13).

In addition to the mentioned Directives, which harmonize the area of financial services sector at the EU level, the Directive on Money Laundering (91/308/EEC) was adopted. Later on, it was supplemented by Directive 2001/97/EC forbidding the use of the financial system for the purpose of money laundering, which is closely related to criminal activities and tax evasion.



1.1.6. EU Public Procurement Legislation

An efficient public procurement system ensures economy, efficiency and transparency in the use of public funds, encourages the competitiveness and equal treatment of bidders in public procurement procedures and provides adequate legal protection. For these reasons, public procurement is regulated by numerous laws at the EU level and this issue is also of great significance for the Stabilization and Association Process.

Existing EU public procurement legislation with which EU accession candidate countries must harmonize their regulations within the first phase of harmonization, can be divided into three parts:

- Public procurement, whereby the clients are bodies of central, regional or local government, is regulated by Directives 93/36/EEC, 93/37/EEC, 92/50/EEC and 97/52/EEC. These Directives regulate the procedures for the award of public procurement contracts, including the rules on inviting bids, time-limits for the submission of bids, as well as the uniform EU standards for setting the technical requirements.
- Public procurement, whereby the clients are entities operating in the water, energy transport and telecommunications services sectors), is regulated by Directives 93/38/EEC and 98/4/EEC (including the amendments to Directive 93/38/EEC).
- Legal remedies or procedures for the protection of bidders' rights are regulated by Directives 89/665/EEC, 92/50/EEC and 92/13/EEC, providing for an efficient and fast procedure for recovery, as well as the cancellation of unlawful decisions and compensation of firms for damages.

1.2. Identification of the Conditions for Conducting the Process of Harmonization

The harmonization of national legislation with EU legislation is a long and very complex process, which includes the adoption of laws and their implementation, formation of appropriate institutions for the enforcement of regulations, modernization of administration and efficient provision of information concerning the necessary changes at all levels of society. The process of integration into the EU also requires numerous new institutions and institutional adjustments (economic, judiciary, police and military reforms, reform of political institutions, etc.).

The European Agreements, European Directives, White Paper, Stabilization and Association Agreements, as well as the ongoing EU negotiations with the countries of Central and Eastern Europe lay down the internal, foreign-policy, economic and social criteria for the harmonization of legislation.

In the case of Serbia, the necessary conditions for harmonization with EU regulations can be observed from several aspects: (14)

- Internal political factors;
- External political factors and



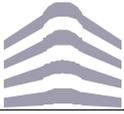
- Administrative factors.

The first precondition for initiating an accelerated process of harmonization is to reach a political consensus that the country's priorities are integration into the EU and harmonization of the internal system. Political about-turns and frequent changes of the regime in almost all countries in transition provide ample evidence that insistence on fast reforms, without a political and social consensus, may easily offset all positive results. Although all political groups have so far supported integration into the EU, at least declaratively, it can be stated that a political consensus has not yet been reached. There is no doubt that the first step in that direction should be the preparation of the EU Accession Strategy, bearing in mind that Serbia is one of the rare countries aspiring to membership in the EU which has no accession strategy. It is also necessary to adopt the Economic Reform Agenda, including the time limits for the adoption of new laws, which should be harmonized with EU regulations. For all laws undergoing the adoption procedure, it will be necessary to check their conformity with the EU regulations. In the opposite, they should be returned for revision.

From a political viewpoint, this implies the development of democratic institutions and practice, rule of law, respect for human rights and the protection of minorities. This also implies free and fair elections, free media, independent judiciary, fight against corruption and economic crimes, protection of the rights of national minorities, as well as the abandonment of the practice to have privileged groups and individuals who are above law.

Without fulfilling specified foreign-policy requirements, the process of harmonization will not have much sense, because Serbia would not be taken seriously by the international community. This refers, above all, to full cooperation with the Hague Tribunal, because, in the opposite, SM will not acquire the status of a candidate; international assistance would be denied, while some milder form of sanctions should not be a priori discarded. At the same time, it is necessary to find the final solution for the status of the State Union, because the process of harmonization cannot be conducted if each republic is conducting its process of harmonization independently, thus raising the problem of harmonization of the internal systems. In addition, without finding the final solution for the status of Kosovo, the accession of Serbia (Serbia and Montenegro) to the EU is not possible.

The EU regulations cover over 90,000 pages and their volume is still increasing. In order to ensure harmonization with so many regulations, it is necessary to have an adequate administrative capacity. It is assumed that for the negotiations with the EU it will be necessary to recruit more than 100 negotiators for different areas. The Office for Accession to the EU, which operates within the Vice-Premier's Office, does not have sufficient human and technical resources for conducting the overall process of harmonization by itself. Therefore, it is necessary to set up a special ministry or a specialized centre for accession to the EU within each



ministry, or to increase the capacity of the existing Office to a significant extent. It is also necessary to use all available forms of foreign technical assistance.

1.3. An Analysis of Transition Countries' Experiences in the Process of Harmonization

Serbia and Montenegro falls into the group of those East European countries that were the last to initiate the process of EU accession. The only advantage of this delay lies in the fact that its process of EU accession can be based on other countries' experiences. This section, which is devoted to an analysis of the experiences of other EITs and their relevance for Serbia and Montenegro, consists of three parts. The first part mostly analyzes the experiences of specified countries in the transition process, which is the unavoidable phase of EU accession. The second part presents the common characteristics of this process and the third part gives recommendations for Serbia and Montenegro.

1.3.1. The experiences of selected EITs in the transition process

Baltic Countries

The easiest way to gain an insight into the transition process in the Baltic countries is probably to analyze the Estonian economic reform. Estonia is not only one of the most successful countries in transition, but was also the leader of other countries in the region, Lithuania and Latvia, in many respects. The Baltic countries have many similarities. They are similar in size and had a similar history within the Soviet Union. They won independence almost simultaneously and their path to a market economy was also similar. But, they also differ among themselves in many respects. In continuation, we will also try to supplement the story about Estonia with some specific features of the transition path of Lithuania and Latvia.

The economic success of Estonia as well as other Baltic countries has been based on stable currency, liberalized foreign trade, and price liberalization, removal of government subsidies, fast privatization and efficient bankruptcy legislation. Efficient restructuring, resulting in a high inflow of foreign direct investment, which has been especially characteristic of Estonia, has followed the fast achievement of economic stability.

From 1991 (when it won independence) to 1995, Estonia was recording a downturn in its economic activity. Encouraged by domestic demand, the economy was abruptly revived in 1997, when its growth rate exceeded 10%. However, in 1998 already, due to the financial crisis in Asia and Russia, the growth rate fell to 4.7% and in 1999, for the first time since 1994, it entered the negative zone. However, thanks to the strong wave of external demand, economic activity was revived in the second half of 1999. In 2000, the growth rate amounted to 6.9% and a similar growth rate was retained during the subsequent years.



A monetary reform was carried out in 1992. The entire monetary system was based on the currency board. The Estonian kroon was tied first to the German mark and then to the euro (since January 1999). At the same time, full convertibility was proclaimed both in current and capital transactions. In 1994, due to their negative experience with a floating exchange rate, Lithuania tied its currency to the SDR (Special Drawing Rights) and Latvia to the dollar.

The implemented measures produced results very fast. The inflation rate in Estonia was reduced from 23.1% in 1996 to 11.2% in 1997. Thanks to a large inflow of foreign capital and sharp increase in property prices, such price stability was also maintained over the next two years. In 1999 already, inflation was abruptly brought down: that same year, it was only 3.3%. From the second half of 1998, producer prices were also declining but in 2000, due to an abrupt increase in the prices of energy products, their stability was disrupted, so that they increased by 0.4% that year. Among the Baltic countries Latvia had the greatest problem with inflation.

Estonia's current tax legislation was largely adopted in the first phase of transition-related reforms. The tax law was adopted in 1994 and amended over time. The new Law on Income Tax came into force on 1 January 2000. It should be noted that Estonia was the first (in 1994) to shift from a progressive tax system to a flat tax one. It was soon followed by Latvia and Lithuania. Their courage paid off: none of these countries recorded any adverse effect on their tax revenues thanks to the lower rate of tax evasion, as well as to a rise in wages, which was partly a result of the flat tax system itself.

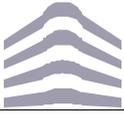
From the very beginning fiscal policy was extremely restrictive so as to support a fixed exchange rate. It was forbidden to borrow from the central bank for the budget³. In 1992, parallel to its monetary reform and with a view to reducing purchasing power and balancing the budget, the Government decided to increase VAT from 10% to 18%. This rate is still in force and is the same in Latvia and Lithuania. In 2001, thanks to the high rate of economic growth, more efficient tax collection and reduced government revenues, the budget surplus of 0.7% of GDP was recorded for the first time since 1997.

Until the late 1990s already, the Baltic countries successfully finished the privatization of small-sized enterprises through vouchers and insider privatization. Estonia and Latvia were trying to find strategic partners for their large systems in which Estonia was especially successful. Lithuania was solving this problem through the distribution of vouchers as well⁴.

The 1990s were marked by significant changes in the labor market. On one side, economic restructuring brought about the new forms of employment and, on the other, there was a

³ In Lithuania and Latvia, the limited financing of the government was permitted. There was an upper credit limit, while credits were most often used for bridging a financial gap temporarily and not for deficit financing.

⁴ The Baltics: Medium-Term Fiscal Issues Related to EU and NATO Accession, IMF, January 2002.



change in the composition of population. In Estonia, the official rate of unemployment, which was very low at the beginning, was gradually increasing during the transition period. In 1997, at the time of the financial crisis in Russia, it amounted to 9.8% and in 2000 it increased to 13.6%. Since 2001, unemployment has been declining, so that in 2002 already the rate of unemployment was only 10%.

Thanks to its liberal economic policy (without exchange control or restrictions on foreign investments) and favorable business climate, Estonia ensured a steady increase in foreign direct investment (FDI), so that the share of companies being in partial or full foreign ownership now account for more than one-third of GDP, while their share in total exports is over 50%. The large inflow of FDI contributed to the fact that Estonia very soon assumed the leading position among the countries of Central and Eastern Europe as regards the level of FDI per capita.

The basic trends in FDI inflow can be summarized as follows: the period 1995-1996, when FDI stemmed mostly from privatization; the period after 1996, when reinvested profit was increasing – in 2004, it accounted for 76% of total FDI inflow; an upward trend in cross-border acquisitions and a mild increase in greenfield investments. According to the IMF⁵, during the period 1995-2001, capital accumulation contributed to the growth of annual GDP in the Baltic countries with 1¾-2 percentage points, while a rise in total factor productivity (TFP) contributed to the average annual growth of GDP with 4¼ percentage points in Estonia, 3¾ in Latvia and 3 in Lithuania.

The vicinity of the Nordic countries' markets, its location between Eastern and Western Europe, competitiveness reflected in low costs, as well as highly skilled labor were the major sources of Estonia's comparative advantage at the beginning of its transition process.

From the very beginning, Estonia supported the free trade principles as those observed in all EU countries. It became a member of the World Trade Organization (WTO) in November 1999.

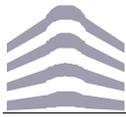
During the period 1994-2001, the Estonian exports to the EU were increasing at the annual rate of 25% on the average. In 2003, more than four-fifths of total exports went to the EU countries. During all transition years, exports were increasing faster than imports, so that Estonia's share in the EU market was also gradually increasing, albeit it is still very slow. A rise in the competitiveness of the Estonian economy can best be observed on the basis of its export structure. In addition to its traditional exports, such as: timber, textiles and foodstuffs, the exports of electric motor spares and components, cables, cell phones, etc. are also increasing. Services are also exported. They include primarily the services related to transport and tourism, as well as to the IT sector and computer technology.

⁵ Competitiveness in the Baltics in the Run-Up to EU Accession, IMF Institute, April 2003, p. 24.



Table 3: Basic macroeconomic data

Estonia	'91	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04
GDP, real growth rates, %	-7.9	-14.2	-8.5	-1.6	4.5	4.5	10.5	5.2	-0.1	7.8	6.4	7.2	5.1	6
GDP per capita, USD	n.a.	632	1,105	1,530	2,405	2,982	3,187	350	266	289	321	334	395	n.a.
Industry, real growth rates, %	n.a.	n.a.	n.a.	-3	1.9	2.9	14.6	4.1	-3.4	14.6	8.9	8.2	17	n.a.
Unemployment, in %	n.a.	n.a.	6.6	7.6	9.8	10	9.7	9.9	12.3	13.7	12.6	10.3	10	n.a.
Inflation, end of year	304	954	36	42	29	15	12	16.8	39.8	9.5	3.7	2.3	5.6	5
Fiscal deficit, % of GDP	-5.2	0.3	0.7	-1.3	1.3	1.9	-2.2	9.5	12.7	9.9	5.5	5.3	5	4.2
Current account deficit, % of GDP	n.a.	n.a.	-1,3	7,3	4,4	9,1	12,2	22,1	14,7	6,6	3,3	3,9	2,8	3,7
Foreign debt, % of GDP	n.a.	n.a.	18.2	23.4	22.1	31.8	55.3	89.9	131.8	124.4	109.6	111.1	102.9	n.a.
FDI net, bill USD	n.a.	156	212	199	111	130	574	87	38	-7	-1	5	17	72
Administrative prices, % of CPI	n.a.	n.a.	n.a.	21.1	18	24	24	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	12
Privatization revenues, % of GDP	n.a.	n.a.	2.26	6.9	9.4	10.6	12.9	1.8	2	2.3	2.7	2.9	3.2	n.a.
Non-performing loans, % total loans	n.a.	n.a.	n.a.	3.5	2.4	2	2.1	0.2	6.4	16.3	13.8	13.3	11.2	n.a.
Stock market capitalization, % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	24.6	0.8	0.4	0.3	0.3	0.5	1.6	n.a.
Latvia	'91	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04
GDP, real growth rates, %	-10.4	-34.9	-14.9	0.6	-0.8	2.8	8.4	4.8	2.8	6.8	7.9	6.1	7.5	7.5
GDP per capita, USD	n.a.	525	848	1442	1779	2070	2293	2757	3032	3268	3511	3949	4771	n.a.
Industry, real growth rates, %	-0.3	-46.2	-38.1	-9.5	-6.3	1.4	6.1	2	-8.8	3.2	6.9	5.8	6.5	n.a.
Unemployment, in %	0.3	3.9	8.7	16.7	18.1	19.4	14.8	14.1	14.3	14.4	13.1	12.4	10.6	n.a.
Inflation, end of year	345	958.6	34.9	26.3	23.1	13.1	7	2.8	3.3	1.9	3	1.5	3.6	7
Fiscal deficit, % of GDP	-2.7	-0.8	3.1	4.4	3.9	1.8	-0.3	0.7	5.3	2.7	1.6	2.7	1.6	2
Current account deficit, % of GDP	n.a.	-19.1	-5.5	0.4	5.4	6.1	10.7	9.8	9.1	6.4	8.9	6.5	8.6	9.4
Foreign debt, % of GDP	n.a.	n.a.	n.a.	n.a.	31.8	39.4	48.4	46.8	52.9	60.9	67.6	75.7	82.6	n.a.
FDI net, bill USD	n.a.	n.a.	50	279	245	379	515	303	331	400	170	374	328	365
Administrative prices, % of CPI	n.a.	6.1	6.1	16.6	16.6	17.8	19.6	20.4	22	22.3	22	20.7	16.3	16
Privatization revenues, % of GDP	n.a.	n.a.	n.a.	0.3	0.7	0.8	2.2	3.1	3.2	3.8	1.1	5	5.2	n.a.
Non-performing loans, % total loans	n.a.	n.a.	n.a.	16.4	7.8	7.2	10.5	6.8	6.8	5	3.1	2.1	1.5	n.a.



THE MEASURES OF PHASE I OF THE ACCESSION OF SERBIA AND MONTENEGRO
TO THE EUROPEAN UNION WITHIN THE STABILIZATION AND ASSOCIATION PROCESS

II The First Phase Of Accession To The EU

Stock market capitalization, % of GDP	n.a.	n.a.	n.a.	n.a.	0.2	3	6.1	5.6	5.4	7.4	8.5	7.3	9.6	n.a.
Lithuania	'91	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04
GDP, real growth rates, %	-5	-21.3	-16.2	-9.8	3.3	4.7	7	7.3	-1.7	3.9	6.4	6.8	9.7	n.a.
GDP per capita, USD	265	374	716	1143	1623	2129	2588	3137	3086	3260	3477	4066	5281	n.a.
Industry, real growth rates, %	n.a.	n.a.	-2.85	-34.4	-26.5	5.3	5	8.2	-11.2	5.3	15.9	5	15.8	n.a.
Unemployment, in %	1.3	4.4	3.8	17.5	16.4	14.1	13.3	13.2	14.6	16.4	17.4	13.8	12.4	n.a.
Inflation, end of year	345	1161.1	188.8	45	35.7	13.1	8.4	2.4	0.3	1.5	2.1	-1	-1.3	3.5
Fiscal deficit, % of GDP	-2.7	-0.8	5.3	4.8	4.5	4.5	1.8	3	5.6	2.6	2.1	1.6	1.7	2.8
Current account deficit, % of GDP	n.a.	n.a.	3.2	2.2	10.2	9.2	10.2	11.7	11.0	5.9	4.7	5.2	6.7	6.1
Foreign debt, % of GDP	n.a.	n.a.	n.a.	12.4	22.8	26.4	32.8	34.2	41.90	43	43.6	44.1	40.6	n.a.
FDI net, bill USD	n.a.	n.a.	30	31.0	72.0	152.0	328.0	921.0	478.0	345	439.0	714.0	142.0	500
Administrative prices, % of CPI	n.a.	16.9	16.2	18.1	20.4	21.5	23.5	19.8						
Privatization revenues, % of GDP	n.a.	n.a.	0,9	1.3	1.4	1.4	1.6	6.7	7.80	9.6	10.6	11.1	12.7	n.a.
Non-performing loans, % total loans	n.a.	n.a.	n.a.	27	17.3	32.2	28.3	12.5	11.9	10.8	7.4	5.8	2.6	n.a.
Stock market capitalization, % of GDP	n.a.	n.a.	n.a.	1	2.6	11.4	17.8	9.7	10.5	13.9	9.9	9.3	17.2	n.a.

Source: Transition Report (1997, 2000 and 2004), EBRD; Note: The 2003 data are estimated and the 2004 ones are projected.

Hungary

Despite the different economic, political and social inheritance of the countries of Central and Eastern Europe, their transition process and economic reforms conducted until their accession to the EU in May 2004 are similar to a great extent if one observes the reformed areas, as well as the implementation of the relevant measures and policies. However, what is specific to each of them is the degree of importance which they attached to specified areas, thus influencing the pace of their reform processes.

Depending on the pace of its macroeconomic and structural reforms, the past 15-year transition period in Hungary can be divided into three phases. The first phase lasted from 1990 to 1994 and was characterized by the activities performed with a view to gradually achieving macroeconomic stability, and radical measures in the field of macroeconomic and institutional reforms. The gradual implementation of macroeconomic reforms was possible thanks primarily to the fact that at the beginning of the 1990s the inherited macroeconomic instability immanent to all ex-socialist countries was much milder in Hungary: prices were increasing, but the country did not plunge into hyperinflation; its foreign debt was heavy but not intolerable; the budget



deficit was also increasing, but public debt was not too heavy. During the 1980s already, Hungary also implemented specified measures towards price and trade liberalization and since the deviations of the official exchange rate from the real one and the need for a monetary adjustment were much smaller than in other transition countries, the initial scope of reform-related activities was much smaller than in other countries in the region. During this four-year period, trade liberalization was gradually continued. It was accompanied by the depreciation of national currency with a view to promoting national competitiveness after the collapse of the COMECON⁶. At the same time, the process of price liberalization, coupled with a gradual decrease in government subsidies, was also conducted. On the other hand, the social consequences of the ongoing transition process were alleviated by a slower decrease in real wages relative to a decrease in GDP, which caused the high pressure of consumption.

In contrast to a gradual macroeconomic adjustment, institutional reforms were much more radical. With the adoption of the package of bankruptcy legislation, the Law on Financial Institutions and amendments to the Accounting Law, the principle of a hard budget constraint was established both at the corporate level and in the banking sector. As a result of the adopted laws, a strict financial discipline was adopted; all insolvent enterprises disappeared from the market, while banks laid down more stringent credit criteria. Bankruptcy proceedings marked the beginning of the privatization of small and medium-sized enterprises and, what is more important, brought about the strengthening of property rights. However, the most significant contribution of the institutional reforms was a change in the behavior of the corporate sector and its strengthening, which turned out to be the vital prerequisite for a successful privatization process and the attraction of foreign direct investment in the coming period.

The first phase of transition in Hungary was characterized by a mild transition-induced recession, which was accompanied by savings overhang, reduction in a deficit in the current account and, at the end of 1993, the relaxation of fiscal policy. This relaxation caused an increase in the fiscal and trade deficits⁷ which reached nearly 10% of GDP, while the accumulated public debt amounted to nearly 90% of GDP.

Table 4: **Basic macroeconomic data**

Hungary	'91	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04
GDP, real growth rates, %	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2	3.8	3.5	2.9	4.0
GDP per capita, USD	3242	3613	3752	4052	4374	4441	4512	4641	4757	4648	5092	6491	8281	na
Industry, real growth rates, %	-18.4	-9.7	4.0	9.6	4.6	3.4	11.1	13.7	10.4	18.7	3.6	2.8	6.4	na
Unemployment, in %	7.5	9.3	11.9	10.7	10.2	9.9	8.7	7.8	7.0	6.4	5.7	5.8	5.9	na

⁶ The COMECON (Council for Mutual Economic Assistance) was an alliance set up in 1949 with a view to promoting the economic development of its members through their mutual economic cooperation. Its founders were the Soviet Union, Poland, Czechoslovakia, Hungary, Bulgaria, Romania, Mongolia, Cuba and Vietnam, which were later joined by East Germany and Albania. Yugoslavia had a status of an observer. The alliance was dissolved in June 1991.

⁷ A deficit in the current account was financed by additional borrowings rather than out of FDI inflow.



Inflation, end of year	32.2	21.6	21.1	21.2	28.3	19.8	18.4	10.3	11.2	10.1	6.8	5.3	5.7	6.2
Fiscal deficit, % of GDP	2.2	7.2	6.6	8.4	6.7	5.0	6.6	8.0	5.6	3.0	4.4	9.3	6.1	5.0
Current account deficit, % of GDP	na	-0.9	9.0	9.4	5.6	3.7	2.1	7.2	7.9	8.7	6.2	7.2	8.9	8.6
Foreign debt, % of GDP	na	58.1	63.7	68.7	70.4	61.1	51.9	58.0	61.1	64.9	65.5	56.6	62.3	na
FDI net, bill USD	1.5	1.5	2.3	1.1	4.4	2	1.7	3.1	3.1	2.2	3.6	2.6	0.9	1.7
Administrative prices, % of CPI	11	10.9	10.8	11.8	12.9	12.8	15.9	17.0	18.2	18.3	18.5	18.9	19.4	17.9
Privatization revenues, % of GDP	0.1	1.2	1.8	2.7	5.9	9.6	12.6	28.6	29.8	30.2	30.6	30.7	31.1	na
Non-performing loans, % total loans	na	Na	25.6	17.6	10.3	7.2	3.6	7.9	4.4	3.1	3.0	4.9	3.8	na
Stock market capitalization, % of GDP	1.5	1.6	2.3	4.2	5.8	12.4	35.2	29.9	36.4	25.8	19.2	17.6	18.7	na

Source: Transition Report (1997, 2000 and 2004), EBRD; Note: The 2003 data are estimated and the 2004 ones are projected.

The second phase of the transition process in Hungary began in March 1995, with the adoption of the stabilization programme which was designed to reduce its trade and budget deficits. The implementation of this programme began by restricting government expenditures to a great extent and implementing a set of export promotion measures. This was accompanied by the downsizing of the public sector, privatization of the banking sector⁸ and public enterprises, as well as the reform of health and old-age pension insurance. Since the privatization process was carried out largely through the stock exchange, it contributed to the further development of the capital market, while the Basle business principles, which were incorporated into the banking sector, decreased its instability to a significant extent. The gradual liberalization of capital inflows was also carried out. This multiplied the level of FDI, while capital outflows remained to be very strictly regulated⁹.

As a result of the carefully selected and combined measures, this period was the most favorable one for Hungary from an economic viewpoint: during the period 1996-2001, the average growth rate of GDP amounted to 4.3%, while at the EU level it was 2.2% and in other CEE countries 4.2%; the difference in per capita income relative to the EU-15 countries' average was reduced¹⁰; economic development was based on a fast increase in exports, investments and productivity¹¹.

At the beginning of 2001, encouraged by such favorable economic results, the Hungarian Government adopted the policy of fiscal and income relaxation – partly with a view to increasing its popularity among voters. Within a very short period, it brought about the explosion of

⁸ The state/social share in the total balance-sheet amount of banks fell from 50% in 1995 to 15% in 1998.

⁹ Each investment in real property abroad had to be officially reported, while institutional investors were allowed to invest only in OECD countries' government and corporate bonds.

¹⁰ In 1995, GDP per capita in Hungary amounted to 45% of the EU average, while in 2001 it reached 51% of the EU average.

¹¹ During the period 1996-2001, the annual growth rate of exports amounted to 17.3% on the average. At the same time, productivity was increasing by 3.1% on the average.



public expenditures, while nominal wages exceeded a rise in productivity by far. The budget deficit was increasing, productivity was sharply declining, while the country's price and cost competitiveness was declining relative to other countries in the region. The inflow of FDI was also declining, so that a higher deficit in the current account was most often covered by short-term borrowings. All this was also contributed in large measure by the lack of coordination and synchronization of the activities and measures of fiscal and monetary policy-makers and especially by their different views on the role of the exchange rate in solving the problems. As a result, during the third transition period (2001-2004), macroeconomic stability was endangered once again: in 2002, the budget deficit amounted to nearly 10% of GDP, while in 2003, after its adjustment, it was reduced to 6%; after several years, public debt began to increase once again, reaching the level of 60% of GDP; prices also began to increase and, as the result of a jump in aggregate demand, caused by a rise in income, a trade deficit also began to increase.

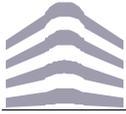
Like in the first transition period, macroeconomic instability over the past four years was accompanied by thoroughgoing institutional reforms. This time, they were a result of the intensified preparations for EU accession and the adoption of the missing laws and regulations as acquired by *acquis communautaire*.

However, most economic analysts have unambiguously concluded that Hungary has not rounded off its transition period or implemented all reforms with its accession to the EU. What it also has to do in the coming period is, first of all, to reduce its public sector, especially through the further reform of health care and old-age pension insurance, educational system and government administration, in addition to solving the problems of unemployment and increased social differences, meeting the nominal and real convergence criteria so as to accede to the EMU, as well as effecting a number of structural changes and adjustments with a view to using the positive effects of accession to the single EU market and alleviating the negative ones.

Poland

The macroeconomic reforms, which were carried out during the period 1989-2004, are regarded as more successful efforts at post-communist transformation in Poland. The underlying reason should be sought in the clear vision of political factors in Poland relating to the general directions of change and the long-term model that should be attained (this refers primarily to a stable and export-oriented market economy). These reforms were adjusted with other reforms, especially in the field of macroeconomic liberalization.

Macroeconomic reforms. The major characteristic of the transition process in Poland is that the change of governments never influences the basic course of macroeconomic policy. It remained relatively firm and promoted macroeconomic stability and the reduction of inflation.



Macroeconomic stabilization. It was achieved through the combination of numerous instruments, including the real positive interest rate and strict control of the fiscal deficit, money supply and revenues. Fixed nominal exchange rates helped in limiting inflationary expectations and building the credibility of the stabilization system. The high devaluation of national currency at the time of trade liberalization led to a rise in export profitability, which temporarily improved the budget and current account balance.

Macroeconomic stabilization would not be possible without the elimination of the basic sources of economic disequilibrium: widespread shortages (deficits). In this regard, the crucial role was played by the ambitious programme of macroeconomic liberalization. At the same time, the removal of price and trade controls, introduction of the convertibility of national currency and the unification of exchange rates enabled a price adjustment and market-based allocation.

Reforms of the entrepreneurial sector. The major steps in deregulation and liberalization are as follows:

- Elimination of most licensing and concessional requirements;
- Implementation of a uniform tax policy in all sectors;
- Adoption of new antimonopoly legislation and deconcentration of the industrial sector;
- Dissolution of all cooperative societies;
- Introduction of customs flows which are in conformity with the EEC standards;
- Abandonment of all remaining types of trade which are not based on the free market principles;
- Further price liberalization;
- Adoption of the new foreign investment law eliminating most licenses and allowing the free repatriation of profit and investment capital, and
- Introduction of current account convertibility.

This policy accelerated the explosion of new firms and FDI inflow.

Privatization. The privatization of state-owned enterprises began in 1990. In Poland this process had two basic characteristics:

- It was largely consensual, since the interests of a wide circle of shareholders were taken into account;
- A gradualist approach, which resulted from a number of reforms.

For these reasons, various methods of privatization were implemented, including sale to investors, by tendering.

Employment policy. Since 1990, employment in the Polish agricultural sector has dropped from 25.2% to 18% of total employment. Transition exerted high pressure on the labor market, which resulted in unemployment. Therefore, one of aims of the reform was to create an effi-



cient labor market and social policy. It was also necessary to create the income system for support to those who have lost their jobs.

Table 5: **Basic macroeconomic data**

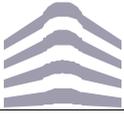
Poland	'91	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04
GDP, real growth rates, %	-7.0	2.6	3.8	5.2	7.0	6.1	6.9	4.8	4.1	4.0	1.0	1.4	3.8	5.5
GDP per capita, USD	2037	2197	2234	2399	3085	3483	3511	4096	4011	4241	4739	4924	5402	na
Industry, real growth rates, %	29.6	2.8	6.4	12.0	9.6	8.3	11.5	4.8	4.4	7.1	0.5	2.0	8.7	na
Unemployment, in %	11.8	14.3	16.4	16.0	14.9	13.2	8.6	10.2	13.4	16.4	18.5	19.8	19.2	na
Inflation, end of year	na	na	37.6	29.5	21.6	18.5	13.2	8.6	9.8	8.6	3.4	0.7	1.7	4.5
Fiscal deficit, % of GDP	na	4.9	2.4	2.2	3.1	3.3	3.1	2.3	1.5	1.8	3.5	3.7	4.2	5.0
Current account deficit, % of GDP	na	1.1	-0.7	0.7	4.5	-1.0	-3.2	4.4	8.1	6.1	2.9	2.7	2.0	2.6
Foreign debt, % of GDP	na	56.4	54.9	47.1	38.0	35.2	36.0	37.3	42.2	42.4	39.3	44.7	50.2	na
FDI net, bill USD	na	284	580	542	1,134	2,741	3,041	6.1	7.2	9.3	5.8	3.9	3.8	5.0
Administrative prices, % of CPI	11.0	14.0	16.0	17.0	17.0	15.0	12.0	10.6	9.0	2.6	1.2	1.0	1.0	1.0
Privatization revenues, % of GDP	0.2	0.4	0.9	1.7	2.6	3.6	5.1	6.6	7.9	11.6	12.5	12.8	13.3	na
Non-performing loans, % total loans	na	na	36.4	34.0	23.9	14.7	11.5	11.8	14.9	16.8	20.5	24.7	25.1	na
Stock market capitalization, % of GDP	0.2	0.3	3.7	3.5	3.9	6.6	9.6	13.0	19.9	18.1	13.7	14.3	17.3	na

Sources: Transition Report (1997, 2000 and 2004), EBRD; Note: The 2003 data are estimated and the 2004 ones are projected.

1.3.2. Common Characteristics of the Process of EU Accession

The Development of a market-based economic system and the harmonization of the economic and legal system represent the necessary steps in the process of assesment to the EU. The undertaken measures regarding the building of market economy represented a first part in the process of the EU accession. At the beginning of the negotiations on accession to the EU, the newly established EU criteria, which the government administration and economic agents in EITs had to meet, were even more stringent as regards harmonization with the new environment. The general conditions for accession to the EU included as follows:

- Building of democratic institutions, establishment of the rule of law, protection of human rights and protection of minorities;
- Establishment of a market economy, able to cope with competition within the EU;
- Development of all administrative structures for the provision of support to the newly established system.



The transformation of the ex-socialist systems started in late 1980-s. The establishment of a market economy, with the conditions for free movement of goods, capital and people, required the development of the transition models of post-socialist countries on the following foundations:

- Macroeconomic stabilization,
- Price liberalization,
- Foreign trade liberalization
- Privatization of enterprises,
- Liberalization of the financial market.

In the process of **macroeconomic stabilization** it can be stated that all EITs, which have acceded to the EU or have acquired the status of a candidate country, have successfully solved the inflation problem (table 7). In 2003, the inflation rates ranged from 1.1% in the Czech Republic to 5.7% in Hungary. Some minor problems are recorded only in Romania, which has a two-digit inflation rate, but it still has time to adjust its inflation rate significantly prior to becoming a full EU member.

In view of the fact that the process of macroeconomic stabilization was conducted parallel to **price liberalization**, a specified time period was required so as to lower the inflation rate to a single-digit one. The problem is all the greater if one bears in mind that for most EITs it implied a shift from the system of price controls to an entirely liberal pricing system. The share of administered prices in CPI differs very much from country to country. In 2004, among the countries which became EU members, it was the lowest in Poland - 1.0% and the highest in Estonia – 26.9%. In Serbia and Montenegro, this indicator was 11.1%. Among the EITs which became EU members, apart from Poland, the lower share of administered prices was recorded only in the Czech Republic (10.9%), while among the candidate countries it was lower only in Croatia (0.0%).¹²

However, these countries were much less successful in dealing with the problem of payments disequilibrium. In 2003, the only country with a surplus was Slovenia, while a deficit in the current account ranged from 12.8% of GDP in Estonia to 1.9% of GDP in Poland (table 7). However, this deficit is largely linked to **foreign trade liberalization**, one of the areas in which the greatest progress was made. Free trade, except for trade in “sensitive” products, has been the main principle and objective of economic relations between the EU and accession countries since 1995. *Free movement of goods implies a number of measures in respect of mutual trade – the abolition of quantitative and qualitative import and export restrictions, applying the same regime to domestic goods as well as imported from other parts of the free trade area (principle of non-discrimination). Beside the free movement of goods, the other element of the Single Market is the common external tariff. The common external tariff was about to be adopted af-*

¹² EBRD, Transition Report, 2004.



ter the formal accession of a candidate country into the EU, but there were certain delays¹³. Some of EITs, which had been applying a zero tariff foreign trade regime, had to raise external protection implying benefits for domestic producers but costs for consumers and importers from the third countries. EITs still need to establish appropriate customs and market surveillance infrastructure as well as effective administrative co-operation between competent authorities.¹⁴

All EITs, which have become EU members or have acquired the status of a candidate country, have also become WTO members. The process of WTO accession is very significant, because it enables liberal trade and harmonization in a number of important areas such as, for example, the rules governing the protection of intellectual property rights.

Capital movements were also in large part liberalized during the initial phase of the accession process. Even though accession negotiations permitted the possibility for the transition periods in some parts of the Acquis, most of the accession countries achieved full capital mobility with both EU as well as with third countries. The only exemptions¹⁵ were investments in real estate and agricultural land, which were subject to the rather full restrictions. As a result, the accession countries experienced a surge in the foreign inflows¹⁶, during the 1990s (table 6), which also influenced real appreciation of the exchange rates of these countries. On the other hand, full capital liberalization in the presence of high international capital mobility, undeveloped monetary instruments, weak financial regulations and to some degree pegged exchange rate (especially in light of the joining the ERM II mechanism) have also raised question and fear of the currency crisis.

Table 6: FDI inflows in chosen CEE countries

Country	Total FDI stock (Mn of EUR)	Total FDI stock (per capita)	FDI inflows, 2000 (Mn of EUR)	FDI from EU share (in total FDI)
Hungary	21 063	2 099	1 790	64%
Poland	31 508	814	10 087	64%
Czech R.	23 503	2 280	4 854	83%
Slovenia	1 659	833	141	81%
Bulgaria	3 579	441	1 057	58%
Estonia	20 931	1 450	260	89%

(*): For the 1989-2000 period

Source: Dimitrijevic, B., 2002, "Comparative Analysis of Costs and Benefits of European Union Accession in the selected countries", SCEPP

¹³For example, Hungary has been granted a transitional period until the end of the third year following the date of accession or 31 December 2007, whichever is the earlier, for compliance with the Common External Tariff as regards the opening of a yearly tariff quota for aluminum.

¹⁴Ramunas Vilpisauskas and Guoda Steponaviciene, 1999., "Winners and Losers of EU Integration in Central and Eastern Europe: The Case of the Baltic States - Economic part" <http://www.freema.org/Projects/BalticCase.phtml>

¹⁵The short-term capital flows are also mainly liberalized, but, as postulated in the negotiations, with some transition period.

¹⁶Naturally, the size and the pace of the foreign investments was not related exclusively to the lifting of the capital restrictions, it was determined by various other factors, see, for example, Bevan, A. and S. Estrin (2000), "The Determinants of Foreign Direct Investment in Transition Economies", [William Davidson Institute Working Papers Series](#) No. 342.



In view of the fact that the EU rules anticipate the dominance of **private ownership**, all EITs, which have become EU members or have acquired the status of a candidate country, privatized their economies to a significant extent in the early phases of EU accession. In the EITs that have become EU members, the private sector's share in GDP ranges from 65% to 80% (Table 7).

The following table provides a comparative survey of movements in the inflation rate, deficit in the current account and the private sector's share in the creation of GDP in the selected EITs and in Serbia and Montenegro.

Table 7: **Chosen macroeconomic data**

Country	Private sector share in GDP, in %	Inflation, 2003*	Current account deficit in 2003, % of GDP
Bulgaria	75	5.6	10.1
Czech Republic	80	1.1	7.1
Estonia	80	1.2	12.8
Hungary	80	5.7	8.9
Latvia	70	3.6	8.7
Lithuania	75	1.3	6.6
Poland	75	1.7	1.9
Romania	70	14.2	5.82
Slovenia	65	4.7	-0.005
Serbia and Montenegro	50	7.8	10.3

* - estimate. Source: EBRD Transition Report, 2004.

The regulation in the field of **financial services** is very important in the process of accession to the EU. Recent amendments to national laws have essentially completed the transposition of the relevant part of the banking *acquis* in all accession countries. The banking sector in these countries has been considered as of high standards in administrative capacity and, in particular, in regulatory and supervisory practices¹⁷. National supervision bodies in the new EU members are now effective organizations with considerable licencing, monitoring and sanctioning powers¹⁸, which was essential given the fragility of emerging financial markets in these countries¹⁹. The remaining issues are related to the further developing of the anti-money laundering mechanism. In addition, transition periods have been agreed mostly in order to settle

¹⁷ European Commission, Regular reports on candidate countries progress towards accession.

¹⁸ Regarding the introduction of the new regulatory bodies in the Accession Countries, Hungary pioneered in April 2000 (*Hungarian Financial Supervisory Authority, HFSA*) with an integrated supervisor, Latvia (*Finance and Capital Market Commission FMC*) followed in 2001, Estonia (*Financial Supervision Authority*) and Malta (*Financial Services Authority*) in 2002.

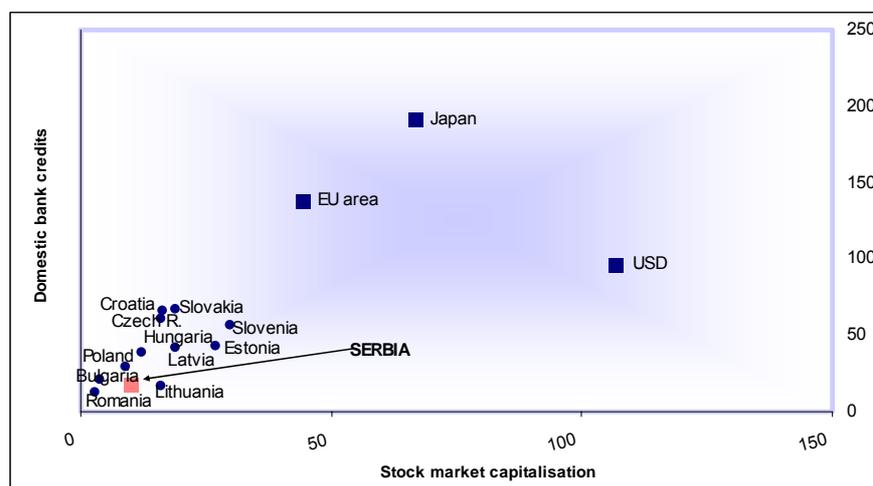
¹⁹ The Czech experience (Hanousek, J. and G. Roland (2002), "Banking Passivity and Regulatory Failure in Emerging Markets: Theory and Evidence from the Czech Republic", Centre for Economic Policy Research Discussion Paper, No. 3122.) is instructive in this respect: soft licencing policy and insufficient supervision led to the explosion of the number of small banks in the early 1990s, many of which, having relaxed their loaning policies to stay afloat, failed a few years later and exposed the financial sector to external risks.



the favorable capital requirements for savings and loan undertakings, as well as for deposit-guarantee requirements and schemes for compensating the investors. The situation in the insurance and investment services and securities market differs somewhat from the generally positive picture in banking. The transposition of the insurance *acquis* has suffered delays and legislative alignment still has not been completed in some of the countries²⁰. The new laws, where adopted, institute new conflict of interest rules, provide additional protections for customers of insurance companies and impose new requirements on the internal workings of the insurance companies to improve corporate governance. The development of equity and bond markets in the transition economies has also been slow²¹. This discrepancy is also reflected in regulatory and supervisory frameworks. The role of bond markets has been limited, mainly due to the low levels of outstanding government securities, which was a result of the combination of low levels of marketable debt carried over from the planned regimes and overall prudent fiscal policy since then.

The following graph shows the development levels of the banking market and stock market, through the share of extended domestic credits in GDP and stock market capitalization. The graph shows clearly that the countries in transition, which have become EU members (or have the status of a candidate country), are significantly lagging behind industrialized countries in terms of the development level of their financial markets. Serbia and Montenegro is lagging behind the EITs that have become EU members, but is in a somewhat more favorable situation than Bulgaria and Romania.

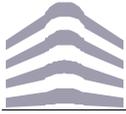
Graph 1: **Banking sector vs. stock market, 2002 (% of GDP)**



Source: EBRD Transition report, 2003 and for Serbia www.belex.co.yu

²⁰ In Hungary, for example, new laws regulating the insurance sector came into effect on 10 June 2004

²¹ The first stock markets in accession countries appeared in the Czech Republic and the Slovak Republic in 1992, as a consequence of mass privatization schemes, followed by Bulgaria, Lithuania and Romania. Recent legal reforms brought up rules of listing the securities to be traded on the stock exchange, protection of the investors and information flows.



The area in which the EITs have made significant progress is a **tax** reform. All observed EITs have introduced VAT, as well as the revised rates of excise taxes, in accordance with the EU requirements.

The adoption of «European heritage» embodied in the *Acquis Communautaire* has also been set as the formal condition for candidate countries' accession to the EU. Adoption of the *Acquis Communautaire* represented a necessary step in the process of the EU accession, which also strengthened the undertaken reforms in the respective countries. The accession countries were expected to implement most of the *acquis*, which amounts to some 90,000 pages of law. It was the question of a long process anticipating the adoption of a great number of laws and sub legal enactments, as well as the translation of regulations into one's native language. The accession negotiations were primarily concerned with determining exemptions from the *acquis* and transition periods during which some specific parts of it would not apply to the applicant country. Each accession country conducted separate negotiations. Such a system implied that each accession country could theoretically enter the EU under different conditions with respect to the implementation of the *acquis*. However, on the most politically and economically sensitive questions the Member States took common positions *vis-à-vis* all the EU applicants. Jacobsen²² estimated that at least 80 percent of the *acquis* was not open to discussion.

The **competition** regulations adopted by all EITs have been mostly harmonized with the *Acquis* provisions in accession countries. In contrast to the establishment of EU free-competition practice which had emerged from the previous experience of the member countries, it was necessary to develop complete regulation from the beginning in the case of the former socialist countries. The adoption of new competition laws, together with the establishment of independent regulatory bodies developed necessary framework for sanctioning of the anti-competitive behaviour. Moreover, the on-going process of the restructuring and later, privatization of some of the large state-owned companies in strategic industries further strengthened the undertaken measures. However, the question of the efficient implementation of the legislative reform was present at the early stages of transformation. Dutz and Vagliasindi²³ showed that most of the early accession countries (apart from Slovenia) were much successful in implementation of the competition policy. Furthermore, they were able to provide robust evidence on positive relationship between more effective competition policy implementation and intensity of competition, which shows that factors related to institutional effectiveness are indeed critical in ensuring that competition policy has its intended economy-wide impact. On the other hand, state aid is the only area of competition policy in which the progress has been slower. The governments in all accession countries used different types of state aid (soft loans, tax benefits or grants to market actors) during the first phase of EU accession in order

²² Jacobsen, C.B. (2001), "Adaptation of the Legal Systems of Candidate Countries – The Case of the Baltic States," DUPI Working Paper No. 2001/8, Copenhagen: Danish Institute of International Affairs.

²³ Dutz, M.A and M. Vagliasindi (2001), "Competition Policy Implementation in Transition Economies: an Empirical Assessment", EBRD Working Paper No. 47.



to ease up the social pressures and protect the potential losers from the transition processes.²⁴

In the initial phases of EU accession, all countries, which have acceded to the EU, had immediately to adjust their regimes in some areas, including the advancement of democracy, observance of human rights (in accordance with the European Convention on Human Rights and the Universal Declaration of Human Rights), observance of international law, adjustment of the regime to the WTO rules, rule of law, elimination of corruption, protection of intellectual property rights, etc. In the process of negotiations the countries themselves could draw the hologram of harmonization with the EU rules in the non-priority areas.

In the early phases of accession, all EITs that have become EU members prepared their EU Accession Strategy, operating plans of harmonization or some other strategic documents showing clearly the path to their accession to the EU.

The EU requested from the EITs to prove their ability to trade among themselves on a bilateral basis, which was one of the extremely important reasons why the Hungarian, Polish, Czech and Slovakian Ministers signed the agreement on the formation of a free trade area at the end of 1992. This agreement came into force on 1 July 1994 and is known as the Central European Free Trade Area (CEFTA). A little later, this association was also joined by Slovenia. This agreement²⁵ was largely modeled on the European Agreement, but the basic difference lied in the fact that all obligations were assumed symmetrically²⁶. The CEFTA did not anticipate free trade in agricultural products.²⁷ This association played a positive role and was dissolved after the accession of its members to the EU.

A similar programme is also anticipated for the countries of South Eastern Europe under the auspices of the Stability Pact. The free trade area in South Eastern Europe anticipates the conclusion of bilateral (often asymmetric) free trade agreements. Under the agreement, 90% of mutual trade should be conducted on a duty-free basis by 2008.

All EITs, which have become EU members or have acquired the status of a candidate country, have also acceded to the Partnership for Peace or NATO. The following table shows the status of these EITs in the Partnership for Peace and NATO.

²⁴ For example (Batory, A. (2003), "The Legal Implications of EU Enlargement: Hungary, Poland and the Czech Republic", European Programme Working Paper May 2003, The Royal Institute of International Affairs) both the Czech Republic and Poland subsidized unprofitable industries, especially the steel sector, to manage social tensions in depressed areas, and the latter also offered tax benefits that would not be permissible under EU state aid rules to businesses investing in special economic zones.

²⁵ The CEFTA represents a mix of bilateral and multilateral agreements.

²⁶ M. Lavigne, "The Economics of Transition", 1995.

²⁷ Under the Agreement, it was stipulated to agree on concessions in trade in agricultural products on a bilateral basis. Two multilateral schemes for a reduction in agricultural tariffs were agreed: for one group of products by 20% within two years and for the other group by 50% within five years.



Table 8: Membership in NATO, Partnership for peace and EU

Zemlje	NATO	Partnerstvo za mir	EU
Hungary	16.3.1999.	8.2.1994.	01.05.2004
Slovenia	29.3.2004.	30.3.1994.	01.05.2004
Estonia	29.3.2004.	3.2.1994.	01.05.2004
Lithuania	29.3.2004.	27.1.1994.	01.05.2004
Latvia	29.3.2004.	14.2.1994.	01.05.2004
Poland	16.3.1999.	2.2.1994.	01.05.2004
Czech Republic	16.3.1999.	10.3.1994.	01.05.2004
Slovakia	29.3.2004.	9.2.1994.	01.05.2004
Bulgaria	29.3.2004.	14.2.1994.	candidate
Croatia	-	25.5.2000.	candidate
Romania	29.3.2004.	26.1.1994.	candidate

Source: www.nato.int and www.nato.int/pfp/pfp.htm

The process of EU accession is a long one and for some countries it lasted more than a decade. The accession countries began the official negotiations on EU membership in the second half of the 1990s and concluded them in December 2002.²⁸ The following table shows the path from the European Agreements to the acquisition of full membership in the EU for the selected countries in transition.

Table 9: Time line of activities made by some new EU members

Ex-candidate countries	EA/SAA ²⁹ signed	EA put in force	Date of application	Negotiation started	FTA with EU established	EU full-membership
Hungary	Dec, 1991	Feb, 1994	Mar, 1994	Mar, 1998	2002	May, 2004
Czech R.	Oct, 1993	Feb, 1995	Jan, 1996	Mar, 1998	2002	May, 2004
Poland	Dec, 1991		Apr, 1994	Mid-1998	2002	May, 2004
Slovakia	Oct, 1993		June, 1995	Mid-2002	2002	May, 2004
Slovenia	June, 1996	Feb, 1999	June, 1996	Mid-1998	2002	May, 2004

Source: Dimitrijevic, B., 2002, "Comparative Analysis of Costs and Benefits of European Union Accession in the selected countries", SCEPP and www.europa.eu.int

Accession to the EU also requires a specified level of economic development, because, in the opposite, the EU would have to earmark excessive funds for underdeveloped regions. The following table provides a comparative survey of movements in GDP and the growth rate of GDP in the EU, selected new EU member countries and candidate countries. The table shows clearly that Bulgaria and Romania, which have the status of a candidate country, are significantly lagging behind the countries that have become EU members as regards the level of their GDP.

Table 10: GDP of EU-15 and chosen CiT

Country	GDP in € billion, in 2002	GDP per capita in € in 2002*	GDP as % of EU average in €	Growth rate of real GDP in 2002, in

²⁸ The Czech Republic, Estonia, Hungary, Poland, and Slovenia started the negotiations in 1998 and Bulgaria, Latvia, Lithuania, Slovakia, and Romania in 2000.

²⁹ For Serbia and Montenegro, Croatia and Macedonia, Stabilization and Association Agreements have the role of European Agreements.



Czech Repub-	73.8	14.4	60	2.0
Estonia	6.9	10	42	6.0
Hungary	69.9	13.6	57	3.3
Latvia	8.9	8.5	35	6.1
Lithuania	14.6	9.4	39	6.7
Poland	200.2	9.5	40	1.6
Slovakia	25.1	11.4	47	4.4
Slovenia	23.4	17.7	72	3.2
Bulgaria	16.6	5.9	25	4.8
Romania	48.4	5.9	24	4.9
Turkey	191.7	5.5	22	7.8
EU-15	9162.3	24	100	1.0

* in thousands; Source: Eurostat

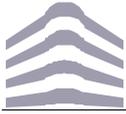
It is also necessary to ensure a functional economy, since EU accession requires the opening of the market to enterprises from other EU countries without any restriction. If domestic enterprises are too weak to withstand foreign competition, there will be the danger of the bankruptcy of a great number of enterprises, rise in unemployment and reduction in economic wealth. This also points to the danger of premature accession to the EU. Among other things, one of the reasons why Bulgaria and Romania still have the status of a candidate country is the European Commission's evaluation that their economies have not yet achieved the sufficient degree of competitiveness.³⁰

1.3.3. Recommendations for Serbia and Montenegro

For Serbia and Montenegro one of the best ways to join European integration processes as fast as possible is to analyze the experiences (the undertaken measures and their results) of the countries that have made the greatest progress in their transition and have become EU members, or have acquired the status of a candidate country for EU accession. There is no doubt that the following relevant conclusions can be derived.

1. The hitherto experiences of EITs show that there is no universal recipe for the transformation of the overall system (i.e. the provision of system-related conditions for the smooth functioning of a market-based system, economic growth and achievement macroeconomic and social stability).
2. The process of EU accession is a long one, because it involves not only an economic reform, but also the adoption of new laws and sub legal enactments, modification of existing ones, their implementation, building of new institutions, etc. Therefore, one must dismiss the wrong idea that it is possible to become an EU member within a short period. Instead, it is necessary to begin the work on EU accession.

³⁰ European Commission, Enlargement Strategy and 2003 Report on the Candidate Countries, COM(2003) 676 final.



3. Macroeconomic stabilization and the liberalization of the regime represent the unavoidable steps in the process of EU accession. In this regard, the starting position of Serbia and Montenegro is considerably more favorable than in most other EITs in view of the fact that at the time of the former Yugoslavia there was a partial market system, which was considerably more liberal than the systems of other East European countries. Serbia and Montenegro has met this requirement in large measure. Its foreign trade regime has been largely liberalized; almost 90% of prices move freely; the budget deficit has been reduced to an acceptable level (it is expected that in 2005 it will amount to 1.5% of GDP), but there is some concern over inflation. Although in 2003 the inflation rate was a single-digit one (7.6%), in 2004 it increased to 13.5%, and a similar inflation rate is also expected this year. Although the inflation rate is similar to that recorded in Romania, restrictive measures are necessary so as to prevent inflationary expectations and an inflation/exchange rate/wage spiral. A high deficit in the current account is unviable in the long run, but it does not deviate more significantly from those in other EITs that have already become EU members.
4. Accession to the EU requires the dominance of private ownership. In Serbia and Montenegro there have been several waves of privatization up to the present (in the early 1990s, under the 1997 programme and under the new, 2001 programme). After the adoption of the new Privatization Law in 2001 all requirements were met so as to dynamize the privatization process. This process was very fast in 2002 and 2003, but the new elections brought about its slowdown in 2004. In view of the fact that only 50% of GDP is now created by the private sector, this process must be accelerated.
5. Before entering into the negotiations on stabilization and association, Serbia and Montenegro will have to ensure, or convince the EU that it has established full cooperation with the Hague Tribunal and that it is characterized by the rule of law, advancement of democracy, respect for human rights, observance of international law and the promotion of good neighborly relations.
6. During these negotiations it will be possible that Serbia and Montenegro itself proposes the hodogram of harmonization activities in a number of fields. Therefore, it is necessary to begin preparations now. The successful process of EU accession is inconceivable without the EU Accession Strategy. Therefore, the work on the Strategy should be completed as soon as possible.
7. Capital movements in S&M have not yet been liberalized in full. This is partly justified because of a high payments deficit and the danger of the outflow of foreign exchange reserves. It is already necessary to draw up the plan for the gradual liberalization of capital transactions.
8. Bearing in mind the great number of regulations that should be harmonized, it is necessary to start with their adoption as soon as possible, even before the formal conclusion of the Stabilization and Association Agreement. It is also necessary to begin with the translation of *acquis communautaire* as soon as possible.



9. It is necessary to ensure full participation in the free trade area in South Eastern Europe. This implies the ratification of the remaining agreements and completion of the ongoing process of revising the agreements, as well as refraining from changes in the tariff system which are not in conformity with the signed agreements.
10. Although that is not a formal requirement, it should be noted that no country has joined the EU without previously becoming a NATO member. Despite great resistance to the NATO in Serbia due to the events from the recent past, it is necessary to meet all requirements for accession to the Partnership for Peace urgently and those for accession to the NATO immediately before EU accession.
11. Without acquiring full membership in the WTO it is highly unlikely that Serbia and Montenegro can acquire the status of a full EU member. The process of accession to the WTO has been slow without any justification, first because of the “stubborn” insistence of the Milošević regime on the continuity of the FRY with the SFRY, and then because the two republics could not agree on the common tariff system. After the approval of the so-called double track approach, the two republics (Serbia and Montenegro) submitted separate applications to the WTO.³¹ Therefore, it is necessary to perform a number of activities so as to accelerate the process of accession to the WTO. The most important activities include the removal of non-tariff barriers; abolition of subsidies, except the permitted ones (primarily in agriculture); harmonization of the regulations relating to the protection of intellectual property rights; removal of technical barriers to trade, etc.
12. EU accession will also require the raising of the level of GDP. The country's current average of 23% of the EU's average GDP is significantly below the level of the new EU members.

Finally, one must bear in mind that Serbia and Montenegro's process of EU accession will also be influenced to a degree by some external factors on which it will be impossible to exert any influence. The EU's experience with its new members will also be of great importance.

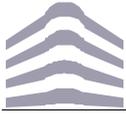
2. HARMONIZATION – INSTRUMENTS, INSTITUTIONS AND TIME-LIMITS

2.1. Free Movement of Goods

One of the basic principles of the single EU market is that goods, which are traded on the market of one EU member country, can move freely through other EU member countries. In order to implement this principle, all tariff and non-tariff barriers to the free movement of goods between EU member countries must be removed.

The issue of tariff and nontariff barriers to trade is of utmost significance for the functioning of a single market. Therefore, it has been embodied in the Treaty establishing the European Un-

³¹ According to the WTO regulations, such an approach is possible, since its members do not have to be states; they can also be the territories with an independent tariff system and full control over it.



ion, all European Agreements, as well as the Stabilization and Association Agreements concluded with EU accession candidate countries. All hitherto concluded agreements contain the provisions³² on the removal of tariffs, quantitative restrictions on imports and exports, as well as measures having an equivalent effect. In a broader context, the issue of free movement of goods is also related to competition policy (as regards the problem of state monopolies, government assistance and granting of exclusive rights by the government) and tax policy (as regards the problem of different tax treatment of domestic products and products from other EU member countries), which are a special subject of an analysis in this Study, so that they will be analyzed in the relevant sections.

Since none of the provisions of the Treaty establishing the European Union define the concept of goods in question and what a trade barrier implies and for the purpose of removing the obstacles arising from different national regulations, the principle of mutual recognition of legislation has been applied since the 1980s. According to this principle, products which are legally produced and/or sold in one member country can move freely among other EU member countries, regardless of whether this is in conformity with the regulations adopted in those member countries. In the areas where there are great differences between legislations, regulations must be harmonized.

In EU legislation there is no strict definition of the term «measures having an equivalent effect» – the given measures are understood to imply all discriminatory provisions (in addition to regular tariffs and quantitative restrictions) which may influence trade between member countries. In the views and reports of the European Commission and case law of the Court of Justice it is stated specifically what can be understood under the term «measures having an equivalent effect». Such measures include the measures relating only to imported products (measures which are discriminatory by nature, like import licences or measures setting the maximum or minimum price above or below which imports are forbidden, reduced or are subject to the conditions which aggravate imports); measures which are, despite being applied both to imported and domestic products, more respective vis-à-vis imported products in practice (such as the provisions concerning the designation of origin or the obligation to appoint the representative for the territory of a given country) and measures which, despite affecting both domestic and imported products, can be regarded as disproportionate to their aim. The measures aggravating trade between member countries can also include all administrative obstacles arising from the procedures for obtaining various licences, which should also be eliminated.

EU accession candidate countries are gradually (within a specified period of time) establishing a free trade area with the EU, in accordance with the provisions of the the Treaty establishing

³² Customs duties and other charges are stipulated by Articles 9–12, while quantitative restrictions on imports and exports, as well as measures having an equivalent effect are stipulated by Articles 30–36 of the Treaty establishing the European Union.



the EU, GATT and the Agreement establishing the World Trade Organization. In the first phase of the EU accession process, these countries are required:

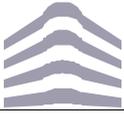
- To adopt and implement the Combined Nomenclature for the classification of goods in mutual trade;
- To gradually lower tariffs and eliminate all measures having an equivalent effect and
- To eliminate all quantitative restrictions and measures having an equivalent effect.

In the second phase of accession to the EU, it is anticipated to harmonize legislations with respect to the weight, content, labelling, production and description of products, thus creating preconditions for the application of the principle of mutual recognition.

During the 1990s, the policy of the Federal Republic of Yugoslavia (FRY) was distinctly a protectionist one. It included numerous protectionist measures, such as: high tariff rates, licences, qualitative and quantitative restrictions, the obligation to report each foreign trade transaction, etc. During the period of sanctions, domestic trade policy was characterized by a significant degree of government intervention. Tariff policy was not transparent, while the complex mechanisms of import and export licences and approvals posed a serious obstacle to foreign trade flows.

After the changes enabling the FRY's opening to the world, comprehensive reforms were also initiated in the area of foreign trade. So, changes in the existing laws and regulations were effected. The most important laws and sublegal enactments regulating foreign trade are the Law on Foreign Trade Operations, Customs Law, Law on the Customs Tariff and the Decision on the Classification of Goods into Import and Export Forms.

The initial steps towards trade liberalization in Serbia were made in 2002 when the compulsory registration for engaging in foreign trade, compulsory notification about foreign trade transactions and a dual exchange rate were abolished. After the introduction of the convertibility of the dinar into current account transactions, the administrative procedure relating to payments for imports was simplified, while the responsibility for transactions was transferred to commercial banks. In 2001, imports were further liberalized by abolishing the earlier protective instrument – import quotas. After the implementation of the relevant measures, most products are subject to the liberal import regime. Under the regime of import licences there is only 1.7% of tariff items, classified according to the Customs Tariff. Most exported goods are subjected to the liberal regime and only a smaller number of products is subject to the regime of quotas and licences. During the same period, the customs regime was significantly liberalized by reducing the number and amount of tariff rates. The new Customs Tariff anticipates only 6 tariff rates ranging from 1% to 30%, with the average weighted tariff rate of 9.37%. Other protective measures with an equivalent effect were not implemented more significantly during the previous period.



The new Customs Law was adopted in July 2003. It was drafted according to the EU Blueprints and the best practice of EU member countries' customs legislation. The provisions of the new Law are in conformity with the views of the World Trade Organization and World Customs Organization, as well as the provisions of the General Agreement on Tariffs and Trade (GATT), especially with respect to the customs value, origin of goods, customs procedure, protection of intellectual property rights, etc.

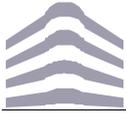
In 2001, within the Stability Pact, Serbia and Montenegro³³ (SM) signed the Memorandum of Understanding, Trade Liberalization and Trade Incentives with the countries of South Eastern Europe (SEE) with a view to promoting trade and its liberalization. This Memorandum provided a basis for the bilateral foreign trade agreements concluded and ratified with Bosnia and Herzegovina, Croatia, Bulgaria, Romania and Macedonia, while such agreements with Albania and Moldova have been concluded but not yet ratified. Apart from the agreements within the SEE Stability Pact, free trade agreements were also concluded and ratified with the Russian Federation in 2000 and with Hungary in 2002. The development of a free trade area in South Eastern Europe is one of the EU preconditions which must be met by candidate countries.

One of the most important conditions for the process of harmonization with the EU rules is the harmonization of the foreign trade regimes of Serbia and Montenegro and the creation of a single market. To this end, in July 2003, the Action Plan relating to the harmonization of the economic systems of Serbia and Montenegro was adopted, including tariff rates and the pace of their implementation. Under the Action Plan, the tariff rates for 93% of products have been harmonized, while the time-limits for the harmonization of the remaining ones are 18 or 24 months. The greatest problem is posed by the harmonization of 56 agricultural products whose tariff rates have not yet been agreed.

The trade liberalization measures can be regarded as a positive and an important step towards harmonization with the relevant EU rules. In the coming period, the basic harmonization aims will be as follows:

- Further work on the harmonization of the economic systems of Serbia and Montenegro;
- Ratification and implementation of all remaining free trade agreements in SEE;
- Gradual lowering of tariffs in specified sectors and the elimination of all legally possible measures having an equivalent effect;
- Adjustment of the Customs Tariff with the EU Combined Nomenclature;
- Lifting of all remaining quantitative restrictions and
- Further work on the implementation of the new Customs Law and improvement of customs procedures.

³³ The State Union of Serbia and Montenegro was formed after the adoption of the Constitutional Charter in February 2003.



<p>Policy Objectives</p>	<p>HARMONIZATION OF THE ECONOMIC SYSTEMS OF SERBIA AND MONTENEGRO, FORMATION OF A FREE TRADE AREA IN SEE, LOWERING OF TARIFF RATES AND ELIMINATION OF MEASURES HAVING AN EQUIVALENT EFFECT</p>
<p>/ Comments</p>	<p>Harmonization with the EU Combined Nomenclature also requires the adoption of changes in the Harmonized System nomenclature concerning tariff names and codes of goods, which came into force on 1 January 2002. The latest changes in the Harmonized System include about 350 changes relating to tariff names, tariff codes, comments, additional comments, etc. Changes in the Harmonized System nomenclature are the result of technological progress and the development of new products. Namely, the volume of trade in these products is so large that they should be recorded under separate tariff items. Tariff items have also been anticipated for various products covered by numerous international conventions (e.g. CITES – Convention on the International Trade of Endangered Species, Basle Convention on the Control of Transboundary Movements of Hazardous Wastes, Convention on Narcotic Drugs and Psychotropic Substances, etc.).</p> <p>The current Customs Tariff has about 8,500 tariff items, while with the mentioned changes the new Customs Tariff would have about 10,000 tariff items. The new Customs Tariff would ensure the unhindered incorporation of future modifications and additions by the World Customs Organization and the European Union. This is very important, because the European Union adopts the new Tariff each calendar year, so that our country will also have to adopt the new Tariff each calendar year.</p>
<p>Competent Institution</p>	<p>Ministry of Finance of the Republic of Serbia; Government of the Republic of Serbia; Council of Ministers of Serbia and Montenegro.</p>
<p>Recommended Time Frame</p>	<p>By the end of 2004 it will be necessary to harmonize the economic systems of Serbia and Montenegro in full.</p> <p>The remaining free trade agreements should be ratified in the Parliament of SM by emergency procedure.</p> <p>The policy of lowering tariff rates should be implemented according to plan and gradually.</p>

The following matrix contains the recommendations and activities relating to the removal of restrictions and administrative barriers to trade, which come within the competence of the Ministry for International Economic Relations of Serbia and Montenegro.

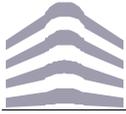


Policy Objectives	REMOVAL OF QUANTITATIVE RESTRICTIONS, MEASURES WITH AN EQUIVALENT EFFECT AND ADMINISTRATIVE BARRIERS TO TRADE
Activities Performed To Date	By amending the Law on Foreign Trade Operations in 2001, it was possible to carry out substantial trade liberalization. Import quotas were abolished, while import licences were retained only for a small number (1.7%) of tariff items, classified according to the Customs Tariff. As for exports, export quotas are now applicable only to a small number of products so as to secure the supply of the domestic market. Only 1.1% of tariff items has remained under the regime of export licences.
Recommendations / Comments	In the coming period it will be necessary to solve the problem of ferrous metallurgy products which are still subject to the regime of import licences. Quantitative restrictions on imports of 160 ferrous metallurgy products should be gradually lifted, in accordance with the programme of liberalization of this industry. For a specified number of agricultural, food and leather products the liberal export regime has been temporarily replaced by export licences (in Serbia), which is not in conformity with the signed Memorandum of Understanding, Trade Liberalization and Trade Incentives in SEE.
Competent Institution	Ministry for International Economic Relations of SM, Government of the Republic of Serbia
Recommended Time Frame	All quantitative restrictions should be lifted by the end of 2004.

2.2. Free Movement of Capital

The free movement of capital is one of four freedoms emphasized in the Treaty of Rome already (in addition to the free movement of goods, services and people). The programme relating to the formation of a single internal market anticipated the full liberalization of capital flows (Article 56 of the Treaty establishing the EEC). However, this liberalization of capital flows was carried out gradually. With the adoption of the First Directive in 1960, most long-term capital flows were liberalized. Under the Second Directive adopted in 1962, dealing in securities was regulated. After the oil crises in the second half of the 1970s and early 1980s, medium-term capital flows were gradually liberalized (1986), which was followed by the liberalization of all short-term capital flows (1988).

Liberalization of capital flows is a precondition for the opening of the internal market and accession to the EU. In the first phase of harmonization of our legislation and practice with EU legislation and practice, it is necessary to liberalize all long-term and medium-term capital flows, as well as current foreign exchange transactions. Liberalization measures are also important for the attraction of foreign capital, integration into the world economy and facilitation of financial sector development. The main obstacles to the free movement of capital flows have



been mostly removed under new legal solutions, but there are still numerous deficiencies which have to be eliminated.

Our financial market is in the initial stage of development. The situation relating to financial instruments is as follows (17):

- The most frequent security has so far been commercial paper issued by enterprises, with very short maturities (up to 30 days) and high interest rates; commercial paper was issued by enterprises so as to obtain fresh financial resources in the absence of bank credits;
- Dealing in shares has actually started with the beginning of privatization; a significant impetus to the development of the share market is provided by the sale of shares in the ownership of the Share Fund;
- The most significant bonds on the bond market are old foreign exchange savings bonds, because they were the first long-dated debt instrument traded on the Belgrade Stock Exchange;
- Treasury bills with the maturity of 91 days appeared in April 2003; thus, in addition to the exchange rate, one more indicator of economic stability was introduced – the interest rate;
- The financial derivatives market is not developed.

As for financial institutions, it can be concluded that numerous institutions immanent to developed financial markets do not exist. Numerous laws, which are being prepared or will come into force, will create a formal basis for the establishment of the non-existent institutions. It is expected that the Law on Insurance, Law on Pension Funds and Law on Investment Funds will be adopted, thus rounding off the legal framework for the formation of investors in the long run. The new Securities Law, which came into force on 1 October 2003, provides for the introduction of numerous elements that should ensure the functioning of the financial market in a more efficient way: the issuing and transfer of securities in electronic form (dematerialization); introduction of market-making business; development of the functions of a custody bank; introduction of certificates of deposit; the possibility of bond issue by domestic companies in foreign currency, etc. The Central Register started to operate on 1 January 2002; its basic function is to keep the uniform records of security issuers, securities paid and their holders.³⁴

The successful completion of the privatization process, development of institutional investors, tax concessions and the removal of obstacles to foreign investors, protection of investors and a more active government's role through the issuing of its own securities are the changes that should especially strengthen our capital market.

³⁴ Before the establishment of the Central Register, there was the Provisional Register for privatization shares, but it did not have the custodian, clearing and settlement functions.



The liberalization of capital flows within the EU was based on several principles:

- No distinction is made as to the source or purpose of capital;
- Capital transactions are freed from control and foreign exchange restrictions, while the rights to such free transactions are conferred to residents and not to citizens;
- Exemptions from the above are possible only if there is a threat to national security, or to the public interest.

Higher efficiency in the distribution of capital in the EU instilled the necessary self-confidence in the EU to initiate the liberalization of capital flows to non-member countries in a similar way.

In Serbia, current foreign exchange transactions have been fully liberalized. Under the current Law on Foreign Exchange Transactions, business partners are given full freedom to negotiate about the dates for the collection of payments for exported goods and services, as well as payments for imports. The only obligation is to register export and import transactions as credit transactions, if the time of delivery is longer than 90 days. The procedure relating to foreign exchange payments/collections arising from current transactions is conducted without greater problems.

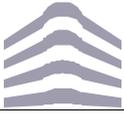
As for capital transactions, there are certain restrictions with respect to residents, including specifically as follows:

- Payments and transfers related to the acquisition of title to real estate abroad are not allowed (special cases are regulated by international agreements);
- Payments related to the purchase of foreign securities and investing in foreign investment funds are also not allowed;
- It is not allowed to open a foreign exchange account abroad, except in special cases subject to the approval of the NBS (i.e. for the construction of capital projects abroad, payments to cover the costs of representative offices, as well as payments in connection with foreign donations).

The new Foreign Investment Law gives the legitimate right to all foreign investors to transfer, without any restrictions and delay, the profits, remainder of the assets upon dissolution of an enterprise with foreign capital; proceeds from the sale of shares, as well as the proceeds from a reduction in the initial capital of an enterprise with foreign capital. Prior to the transfer of monies, the foreign investor must settle all liabilities arising from the corporate income tax and dividend tax.

As for foreign exchange capital transactions, foreign persons have the following options:

- Direct investment in SM (for the formation of a new enterprise, formation of an affiliate, investment in a new or existing legal entity);



- Real estate investment (subject to the reciprocity principle, which means that the investor/buyer must submit to the court the certificate evidencing the observance of the reciprocity principle. At the moment, such a certificate is issued by the Federal Ministry of National and Ethnic Minorities);
- Making of foreign exchange credit arrangements;
- Purchase/sale of securities (excluding short-dated securities)³⁵.

Under the Law on Foreign Credit Transactions, foreign credits can be used, without any restrictions, for the payment of imported goods and services and the financing of the construction of capital projects abroad. However, financial credits for other purposes (whereby financial resources are credited to the account in the country and are, as a rule, converted into dinars, thus having a monetary effect) can be used only exceptionally, if the National Bank of Serbia (NBS) brings a decision on the amount and use of such credits within the Projection of the Balance of Payments. Payments and collections arising from foreign exchange credit transactions between residents and non-residents are unrestricted, while credit transactions between residents and non-residents in dinars are not allowed. All foreign credit transactions must be registered with the NBS.

In order to implement legislation concerning capital flows, it is necessary to meet specified preconditions, including specifically clear investment guarantees, incentive tax regulations, efficient and open financial market and, finally, developed monetary policy instruments.

A stable macroeconomic climate and development monetary policy instruments enable the control of monetary aggregates under conditions of open capital markets.

In EU member countries there were three directives regulating only medium-term and long-term capital flows. On 24 June 1988, with the liberalization of all forms of capital flows, the mentioned directives were abolished and replaced by Council Directive 88/361/EEC.

In view of the fact that long-term transactions are now partly carried out on a short-term basis and that restrictions on short-term capital flows are increasingly diverting foreign capital inflow, the sequence of relevant liberalization measures may follow different patterns, which take into account the specifics of the economic and financial systems.

Policy Objectives	LIBERALIZATION OF CAPITAL FLOWS
	The debt securities market developed in the past due to a weak banking sector.

³⁵ According to the sequence of measures, liberalization of short-term capital flows is planned for the second phase of harmonization and it involves, first of all, trade in monetary-market securities, opening of savings accounts abroad, physical exports and imports of monies, etc. Our residents cannot keep foreign exchange bank accounts abroad, except upon special approval of the NBS.



Policy Objectives	LIBERALIZATION OF CAPITAL FLOWS
<p>State Of Affairs</p>	<p>Most securities are sold with very short maturities and high interest rates.</p> <p>At the end of 2001, the first long-dated debt instruments began to be traded on our financial market. i.e. old foreign exchange savings bonds.</p> <p>Amendments to the Foreign Investment Law enabled the transfer of all financial and other resources stemming from foreign investment abroad in convertible currency.</p> <p>The Foreign Investment Law stipulates the rights of foreign investors concerning liberalized foreign investment, national treatment, legal security, conversion and freedom of payment, the right to keep the books, the right to transfer the profit and assets, and more favourable treatment.</p> <p>The incentives provided to foreign investors include liberalized imports, tax and tariff concessions, as well as duty-free imports of equipment constituting the foreign investor's investment.</p> <p>With the adoption of the new Law on Foreign Exchange Transactions, domestic legislation was harmonized with the EU legislation. So, the conditions for the disposal of foreign exchange were liberalized; market criteria for setting the exchange rate for domestic currency were established, and transparent regulations governing foreign exchange transactions were adopted. Current foreign exchange transactions were also liberalized. Within the scope of foreign exchange capital transactions, foreign entities are given the following options: direct investment, real estate investment, making of foreign exchange credit arrangements and purchase/sale of securities.</p> <p>The Law on Foreign Credit Transactions provides for the unrestricted use of foreign credits for the payment of imported goods and services, as well as for financing the construction of capital projects abroad.</p>
<p>Recommendations / Comments</p>	<p>It is necessary to upgrade the environment and complete the infrastructure required for dealing in shares, as well as to intensify supervision over trading and the functioning of the overall financial market. This can be achieved by amending the Securities Law, adopting the new Insurance Law, Law on Pension Funds and the Law on Investment Funds, thus creating a legal basis for the further development of the financial market and its harmonization with the EU rules.</p> <p style="text-align: center;"><i>Competent institution:</i> Ministry of Finance of the Republic of Serbia</p> <p>It is necessary to intensify the introduction of government securities into the domestic financial market, bearing in mind their significance for market stabilization, lessening of risks, lowering of interest rates, as well as the confidence-building of domestic and foreign investors. At the same time, the issuing of these securities ensures a more efficient financing of the budgetary needs in a different way than in the previous period in qualitative terms.</p> <p style="text-align: center;"><i>Competent institution:</i> Ministry of Finance of the Republic of Serbia</p>



Policy Objectives	LIBERALIZATION OF CAPITAL FLOWS
	<p>It is necessary to establish control over foreign exchange transactions of banks and enterprises by setting up a service within the Ministry of Finance and Economy of the Republic of Serbia, which will be responsible for the control of foreign exchange transactions of legal entities, while the control of banks and other financial institutions should remain within the competence of the Department for Foreign Exchange Documentary Control within the National Bank of Serbia.</p> <p><i>Competent institution:</i> Ministry of Finance of the Republic of Serbia – for setting up a service to control foreign exchange transactions of enterprises, and the National Bank of Serbia – for control of foreign exchange transactions of banks and other financial institutions.</p> <p>The obligation of issuing a special certificate evidencing the observance of the reciprocity principle so as to acquire title to real estate should be abolished.</p> <p><i>Competent institution:</i> Ministry for Human and Minority Rights</p>
Recommended Time Frame	During 2004 it will be necessary to conduct the mentioned institutional and legal reforms, thus contributing to the liberalization of the capital market.

2.3. Competition Policy

Bearing in importance attached by the EU to competition policy³⁶ and all of its aspects in relations with third countries³⁷, there is no doubt that the issue of competition policy will be raised in the context of the Stabilization and Association Agreement. In its Annual Report on SM (in the context of stabilization and association), the EU appealed to SM to take urgent steps to improve its administrative capacity, establish the merger control system and remedy monopoly and oligopoly situations in specified sectors.

Competition policy is viewed from the following four aspects:

- Government assistance;
- Concentration control;
- Restrictive agreements and the abuse of a dominant market position, and
- State monopolies and public enterprises.

To these four areas one should add the efficient implementation of anti-monopoly laws, which is not implicitly mentioned in the relevant EU regulations, but is implied.

³⁶ Great importance attached by the EU to competition policy is also evidenced by the fact that the competition rules were embodied in the Treaty establishing the European Community (Articles 85 and 86).

³⁷ The issue of competition was included in all European Agreements, Stabilization and Association Agreements, as well as Partnership and Cooperation Agreements (Russia, Ukraine and Moldova).



Regardless of the fact that SM has good prospects to become a full EU member in the next 5–7 years, there are many arguments in favour of formulating a new anti-monopoly policy, such as: a change in the inherited uncompetitive market structures; prevention of the creation of new uncompetitive structures, bearing especially in mind the ongoing process of privatization; maximization of public welfare; trade liberalization and the liberalization of domestic prices.

The main objectives of Serbia's new anti-monopoly policy should be as follows(12):

- The creation of an environment that will maximize economic efficiency;
- The adoption and implementation of new regulations governing the area of competition in an efficient way;
- Demonopolization of the public sector;
- Regulation of government subsidies by law and
- A higher degree of autonomy and institutional independence of the Anti-Monopoly Commission.

To attain these objectives in SM, it is necessary to stop to protect inefficient producers and apply the rules of anti-monopoly policy to all domestic and foreign market participants without exception.

2.3.1. State Monopolies and Public Enterprises

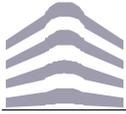
State monopolies, public enterprises and enterprises with special and exclusive rights pose a threat to competition policy due to which they are subject to special regulation.³⁸ According to the relevant EU regulations, special and exclusive rights may be retained only to the extent that is necessary in the common interest, i.e. in the case of public services, for example.

According to Article 37 of the Treaty establishing the EU, state monopolies of a commercial character must be gradually adjusted, so that EU citizens are not discriminated as to the terms and conditions under which goods are acquired and traded after the expiration of the transition period. It is especially stipulated that the exclusive rights relating to imports, exports and wholesale trade should be abolished after the expiration of that period.

In the EU there are still monopoly problems in the sectors providing gas, electricity and postal services. However, the implementation of the measures that should open these sectors to competition is underway.

In Serbia, public enterprises are a rather frequent form of business organization, not only in those sectors which represent natural monopolies, but also in those which can become competitive thanks to their characteristics.

³⁸ The EU regulations do not impose any restrictions on the operations of public enterprises if these operations do not affect competition.



Countries candidates for accession to the EU are required to implement the following measures in the first accession phase:

- In those sectors in which there is no objective of common interest, competition rules must also apply to public enterprises;
- Identification of public services entrusted to specified enterprises and restrictions justifying these enterprises (special or exclusive rights);
- In those sectors in which there is a network of vertically integrated enterprises (like those operating in the gas, electricity, telecommunications and other sectors), it is necessary to make a distinction between their activities in accounting (i.e. production, transmission, etc.);
- A gradual adjustment of state monopolies of a commercial character, so that EU citizens are not discriminated.

The new anti-monopoly regulations must also apply to all public enterprises. Under special legal provisions, it is possible to exempt certain public enterprises from observing certain provisions during the transition period, but not from complete anti-monopoly legislation.

Policy Objectives	DEMONOPOLIZATION OF THE PUBLIC SECTOR
Activities Performed To Date	So far, nothing has been done with respect to demonopolization of the public sector, except the sale of one part of Telekom shares to foreign investors (and the repurchase of one part of them) and determination of the transition period – up to June 2005, when Telekom's monopoly over fixed telephony will be broken up.
Recommendations / Remarks	<p>Some key sectors, such as: telecommunications, power generation and distribution, railway transport, public utilities, gas transport, etc. are characterized by pure monopoly (there only one enterprise), while many other sectors are characterized by oligopoly structures. As the result of such a situation, the prices in some sectors have been formed at an unacceptably high level.</p> <p>It is necessary to identify the services (products) which are in the public interest and then apply the anti-monopoly rules to the remaining ones.</p> <p>For other services (monopolies of a commercial character) it is necessary to anticipate the transition periods of up to five years and gradually introduce competition into this sector as well. After the expiration of the transition period, these sectors must be opened to all other potential market participants.</p> <p>In the sectors in which there is a network of vertically integrated enterprises, it is necessary to make a distinction between their different activities in accounting.</p>
Competent	Government of the Republic of Serbia



Institution	
Recommended Time Frame	During 2004 it will be necessary to identify the services being in the public interest and determine the transition periods for other ones (i.e. other public enterprises).

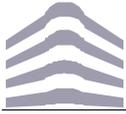
2.3.2. Government Assistance

The question of government assistance is of great political and economic significance. In the ongoing process of transition in SM, the role of specified instruments of economic policy is changing. So, with the development of market mechanisms, the policy of government assistance, which was very important in the previous period, is losing in importance. Therefore, it must be strictly controlled so as not to affect market competition.

Over the past ten or so years, the control of government assistance in the European Union has been gaining in importance. The control and regulation of government assistance are stipulated by Articles 87–89 of the Treaty establishing the EU, coupled with the explicit incorporation of the issue in all European Agreements and all Association and Stabilization Agreements with countries candidates for accession to the EU. In EU legislation the term «government assistance» is not strictly defined. Namely, government assistance is understood to mean any assistance which is provided by the government, or through government funds in any form which will affect, or is threatening to affect competition by favouring certain enterprises, or the production of certain products, and which may influence trade between member states. However, the EU control system does not anticipate total prohibition of government assistance. It has been created in such a way that – despite being based on the principle that any government assistance exerting influence on competition should be forbidden – it provides for government assistance in special cases. Government assistance is unconditionally allowed in the case of:

- Assistance having a social character and being granted to consumers with no discrimination as to the origin of products being the subject of assistance;
- Assistance granted in the case of natural disasters and other emergency situations;
- Assistance granted to enterprises in all sectors except agriculture, fishing industry and transport, if the anticipated sum is up to €100,000 during the period of three years (the *de minimis* rule). In accordance with the WTO rules, this rule is not applicable to assistance linked to export and import substitution activities.

In all other cases, the body authorized to monitor and control government assistance (the European Commission in the case of the EU and national commissions in EU accession candidate countries) approves government assistance according to the adopted directives, frameworks and guidances, which regulate the specific issue of government assistance in a



specific way (the criteria for assessing the justifiability of granting government assistance and the permissible amount) by area:

- Regional development assistance;
- Assistance for enterprise consolidation and restructuring;
- Assistance granted at the national level for research and development, environmental protection, development of small and medium-sized enterprises, employment and training of personnel (horizontal assistance);
- Assistance granted to specify sensitive sectors, such as: media, agriculture, fishing industry, shipbuilding, energy, and transport, car manufacturing industry, man-made fibre industry, as well as coal and steel industry.

In the European Union there is still a relatively wide range of government assistance measures which are grounded in history and tradition and form part of the current policy of government intervention in economic development. The latest available data⁽¹⁸⁾ show that the total amount of government assistance granted in EU member countries in 2000 was about €83 billion (0.99% of GDP) and that this amount is being gradually reduced, in accordance with the programme of reducing government assistance which was adopted at the Stockholm Summit in 2001. Being less developed, the countries that are yet to join the EU may retain the right to receive specified government assistance.

During the previous period, government assistance was widespread in SM's implementation of economic policy. There are still no laws and regulations addressing the issue of government assistance in a comprehensive way. Also, there is no special body that would be authorized to monitor and control the provision of government assistance. The ministries and government agencies grant various types of assistance on the basis of their own assessment of the situation in the area coming within their competence.

EU accession candidate countries are required to take the following measures in the first accession phase:

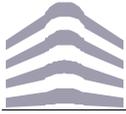
- To set up a special body that will control and supervise the system of government assistance;
- To adopt a special law that will regulate the issue of government assistance uniformly;
- To make a detailed list of programmes of government assistance, which were adopted before the setting up of a supervisory body, and adjust them to the EU criteria during a specified period of time, bearing in mind that, according to these criteria, SM is a region at low development level;
- To assume the obligation to submit to the European Commission annual reports on all plans of government assistance by using EU methodology, on a regular basis.

Government assistance has been, and will remain a very sensitive political issue. The system of government assistance must be the result of a clearly formulated policy of long-term devel-



opment of Serbia's economy, without leaving room for the appearance of various lobbies that may influence the market-based justifiability of the applied measures.

<p>Policy Objectives</p>	<p>ESTABLISHMENT OF AN ADEQUATE SYSTEMIC FRAMEWORK FOR CONTROL OF GOVERNMENT ASSISTANCE</p>
<p>Activities Performed To Date</p>	<p>So far, nothing has been done with respect to the establishment of an adequate legal framework for the regulation of government assistance. The current anti-monopoly law does not mention government assistance at all. Also, there is no special government body authorized to supervise the system of government assistance.</p>
<p>Recommendations / Remarks</p>	<p>It is necessary to adopt a special Law on Control of Government Assistance, which should include the rules governing the procedure of granting government assistance. With the adoption of this law, it would be possible to define as follows:</p> <ul style="list-style-type: none"> • The status and role of the special government body authorized to control and supervise the system of government assistance; • What can be treated as government assistance (subsidies, soft loans, debt write-off, tax concessions, provision of guarantees under preferential terms, etc.); • In which case government assistance is allowed without pre-notification; • In which case it is necessary to seek approval from the body authorized to control the approval of government assistance prior to receiving government assistance by any government body; • The procedure of evaluating the justifiability of granting a specified form of government assistance; • The rights of enterprises, which are directly related to decisions taken by the body authorized to control government assistance, in addition to establishing the procedure for appealing against decisions. <p>It is necessary to set up a special, independent body (the Commission for Control of Government Assistance), which would be authorized to approve the programmes of government assistance and prescribe the restitution of unlawfully received assistance, thus diminishing the possibility of specified sectors to lobby in their favour. After its formation, this body would be obliged to prepare the list of all current programmes of government assistance so as to identify the providers and recipients of government assistance, as well as the programmes under which assistance was granted. As for the unidentified types of government assistance, it is necessary to anticipate the transition period of up to five years during which harmonization with the basic EU rules will be carried out, bearing in mind that SM will be treated as a country with great regional differences in the development level, which is lagging behind the EU average.</p> <p>The Commission would also be obliged to prepare annual reports for the European Commission, specifying the amount, form and objective of government assistance granted in a given year. The Commission should also contribute to the</p>



Policy Objectives	ESTABLISHMENT OF AN ADEQUATE SYSTEMIC FRAMEWORK FOR CONTROL OF GOVERNMENT ASSISTANCE
	<p>improvement of knowledge in government institutions concerning the justifiability of granting specified types of government assistance through the organization of seminars and round tables, as well as the publishing of specified brochures and posting of relevant information on the Commission's website.</p> <p>Bearing in mind that the relevant EU regulations are being continuously improved, in the first phase of harmonization with the EU rules it is not necessary, or possible, to harmonize national legislation with the EU rules in full. Therefore, the objective of this phase should be to adopt the Law on Control of Government Assistance, thus providing conditions for the establishment of an efficient system of government assistance. After the completion of the first phase, some legal provisions will be further improved on the basis of EU experience.</p>
Competent Institution	Government of the Republic of Serbia, including representatives of all relevant government institutions.
Recommended Time Frame	<p>By the end of 2004, all government institutions should begin to prepare reports on government assistance granted in the previous period.</p> <p>During 2004, it will be necessary to adopt the Law on Control of Government Assistance, as well as sublegal enactments regulating the status and powers of the Commission for Control and Monitoring of Government Assistance.</p>

2.3.3. Concentration Control

The integration process is one of the basic factors in the creation of uncompetitive market structure, that is, market power. The integration mechanism includes horizontal and vertical mergers of enterprises. Both types of integration result in the creation of uncompetitive market structures, whereby horizontal mergers do that directly, by reducing competition, while vertical mergers most often act indirectly, by imposing barriers to entry of new competitors.

So far, the control of mergers has not been the subject of SM's anti-monopoly policy. The present Anti-Monopoly Law has no provisions concerning the control of mergers. This Law prohibits the abuse of a monopoly position, but not the formation of monopoly structures itself. The Law does not sanction the actions leading to illegal mergers of enterprises. Instead, it is concerned exclusively with the effects of monopoly structures, such as the reduction of competition and disruptions on the unified market.

For EU accession candidate countries it is anticipated to adopt, during the first accession phase, the essential elements of the concentration control system, as specified by Regulation 4064/89 (EEC). The EU concentration control system includes the elements for laying down the criteria for concentration control and the notion of concentration control, as well as the procedure for exercising such control. According to this Regulation, non-permissible concentra-



tion is any integration creating or strengthening a dominant market position, thus significantly preventing efficient competition on the common market or a part thereof. Under EU law, the notion of concentration is mostly based on the qualitative concept of gaining control.

To exercise concentration control, it is necessary to lay down the appropriate rules for the procedure relating both to the competences of the body in charge of control and the rights of the enterprises in question.

The efficient work of the body in charge of concentration control anticipates the existence of the criteria on the basis of which such control can be exercised. Under the EU Regulation on Concentration Control, the criterion for such control is the total revenue of the company in question. It is also necessary to take into account the delayed effect of initiating the control procedure, as well as the authority to order the elimination of unlawful competition. As the competent body for concentration control, the European Commission has substantial powers as regards the investigation of any possible violation of regulation. These powers also include the right to request information, as well as the right to conduct an investigation on the spot. The Commission also has substantial powers in the area of penal policy, including the imposition of fines to the amount of 10% of the enterprise's turnover, as well as the imposition of periodical payments and emergency administration.

The protection of the rights of enterprises being subject to control is also an important segment of the policy of concentration control. Under EU law, the control of mergers requires strict adherence to the time-limits, so that enterprises are faced with uncertainty as little as possible and can acquire legal security within the shortest possible time. The protection of enterprises also includes the right to be heard, the right of a third party, the provision concerning legal remedy, the protection of business secrets and confidential information, as well as the right to initiate the procedure of recovery.

The current Anti-Monopoly Law does not regulate the issue of integration, nor does it make a distinction between horizontal and vertical integration. Regardless of the fact that both types of integration lead to the creation of monopoly structures, different mechanisms and effects of their creation impose a need for their different treatment by the Law. In some cases, the creation of monopoly structures may generate contradictory effects on economic efficiency and public welfare. On the one hand, some mergers may generate adverse effects due to the creation of market power and, on the other, may result in the realization of economies of scale, i.e. a reduction in unit costs, as well as the improvement of business efficiency and public welfare. It is evident that in deciding on a change in the market structure, one should take into account the overall effect of each merger.



Policy Objectives	CONCENTRATION CONTROL
Activities Performed To Date	The Ministry of Trade, Tourism and Services of the Republic of Serbia started to prepare a draft of the new Anti-Monopoly Law.
Recommendations / Remarks	<p>Concentration control must form part of new anti-monopoly legislation.</p> <p>New regulations should oblige the buyers of enterprises to obtain approval (should they exceed the limit for compulsory notification) prior to the conclusion of a contract of sale or privatization.</p> <p>The mechanism of concentration control should anticipate compulsory reporting on the part of such enterprises, as well as the granting of approval prior to integration. All enterprises being subject to reporting (e.g. those exceeding the limit for notification) must refer to the anti-monopoly institution and seek approval for their merger activity. It is necessary to establish the standard notification limit for all mergers, the best solution being total annual revenue. The best solution would be to use total annual income. The notification limit should be based on the joint revenue of all merging enterprises, as well as the minimum revenue of one of the merging enterprises. Only if both criteria (notification limits) are met, the merging enterprises should be obliged to report their merger. The parties should be required to provide standardized information in their applications for approval.</p> <p>The anti-monopoly institution must bring its decision within a relatively short period, but not longer than 60 days.</p> <p>The legal framework for disputing a merger should be reasonable discretionary assessment. This method of decision-making would introduce flexibility into decision-making and enable the consideration of all effects of horizontal and vertical mergers. The burden of proof should be on the anti-monopoly institution, i.e. it must be assumed that all mergers promote competition and that the task of the anti-monopoly institution is to prove to the contrary.</p> <p>To lay down the principle of reasonable discretionary assessment, it is necessary to have an appropriate decision-making criterion. In this regard, it is necessary to use the dominance test as the criterion. This test has been harmonized with the EU standards and it consists in testing the effects of integration against economic efficiency and economic welfare. Otherwise, the test procedure should be regulated by sublegal enactments.</p>
Competent Institution	Ministry of Trade, Tourism and Services of the Republic of Serbia
Recommended Time Frame	The new Anti-Monopoly Law should be adopted by mid-2004.



2.3.4. Restrictive Agreements and the Structure of a Dominant Market Position

The conclusions of restrictive agreements as well as the abuse of a dominant market position are strictly forbidden under the relevant EU laws and regulations (Articles 85 and 86 of the Treaty establishing the EU).

In the first accession phase, countries candidates for accession to the EU should harmonize their legislation with the key elements of the Treaty establishing the EU, as set forth in Item 1, including the exemption principles, thus creating conditions for the establishment of the system of competition. At the same time, it is necessary to provide conditions for an efficient implementation of regulations. In this regard, the process of liberalization and implementation of measures devised to introduce a market economy are indispensable. For a consistent implementation of competition policy it is extremely important to set up the bodies authorized to enforce these regulations, as well as to establish an efficient judicial system.

In Serbia, the issue of competition is formally regulated by law. Restrictive agreements and the abuse of a dominant market position are regulated by the federal Anti-Monopoly Law³⁹, while other rules, which regulate unfair competition, are embodied in a number of other laws. The central body authorized to establish and sanction the abuse of a monopoly, that is, dominant market position and monopoly agreements is the Anti-Monopoly Commission, which has been functioning at the republican level since the adoption of the Constitutional Charter. However, the current legal solutions have many omissions and deficiencies, so that they must be harmonized with the EU policy and regulations. On the other hand, the Anti-Monopoly Commission, as the competent institution, was practically not functioning in the previous period.

The most serious objection to the current legal solution is related to the fact that the Law does not sanction the creation of a monopoly or dominant position on the market. Instead, it sanctions the abuse of such a position. In other words, the Law is concerned exclusively with the prevention of its effects, without considering the reasons that brought about the rising of market power.

Since the Law does not address the issue of integration, it is clear that it does not make a distinction between horizontal and vertical restrictive agreements. This is a great deficiency if one bears in mind that horizontal agreements (cartels) represent a serious and direct danger to competition. On the other hand, vertical agreements can have a favourable effect on competition.

Under the present Law, a dominant market position is defined as the non-existence of more substantial competition in the production of, or trade in certain products, or in the provision of

³⁹Official Gazette of the FRY, No. 29/96.



certain services. The term «substantial competition» is not sufficiently precise, thus providing wide scope for discretionary decision-making on the part of the Anti-Monopoly Commission. The provision under which the Anti-Monopoly Commission should establish the existence of one's monopoly or dominant position as a fact only after finding out that such a position is abused, is also disputable. Namely, the Law does not stipulate that the Anti-Monopoly Commission or any other government or regulatory body can apply any preventive measures before establishing the abuse of a dominant market position as a fact.

Bearing in mind the mentioned deficiencies, it is necessary to adopt a new law as a basis for the adoption of the EU standards. The establishment of the legal framework should be followed by the formation and strengthening of the institutions authorized to regulate competition.

Policy Objectives	LEGAL DISTINCTION OF RESTRICTIVE AGREEMENTS
Activities Performed To Date	The Ministry of Trade, Tourism and Services of the Republic of Serbia started to prepare a draft of the new Anti-Monopoly Law.
Recommendations / Remarks	<p>Horizontal agreements, that is, cartels are the most frequent and most significant type of uncompetitive behaviour in Serbia. The origins of these agreements should be sought in the current practice to treat enterprises as partners and not as competitors. On the other hand, vertical agreements, which represent the source of competition in domestic circumstances, are not addressed separately from horizontal agreements by the current Law. Moreover, they are cited as an example of monopoly agreement. Since there are no legal grounds for control of integration, the consistent implementation of the current Law in our circumstances stimulates the creation of uncompetitive market structures and deviant behaviour of economic agents.</p> <p>It is necessary to single out agreements that affect competition and apply different provisions to them. To this end, it has been proposed to classify agreements into three types of agreement.</p> <p>The first type of agreement would include cartels, that is, horizontal agreements directed against free competition. This type of agreement includes collusive pricing agreements (including collusive agreements on the fixing of tenders), as well as collusive agreements on market sharing and restrictions on production. All of them should be included in the numerus clausus list and prohibited as such or, in other words, treated as a criminal act. As for these agreements, they should not be subject to exemption, relief or the de minimis rule. In this case, the anti-monopoly institution would only be authorized to establish the facts, since these agreements are forbidden per se.</p> <p>The second type of agreement would include all other horizontal agreements. They would not be forbidden per se; instead, they would be subject to reasonable discretionary assessment, as specified by sublegal enactments. The Law should provide for an illustrative list of these agreements, which would be treated as violations should they be contrary to the Law. This type of agreement is sub-</p>



Policy Objectives	LEGAL DISTINCTION OF RESTRICTIVE AGREEMENTS
<p>Recommendations / Remarks</p>	<p>ject to restrictions and the de minimus rule. In the case of these agreements, the anti-monopoly institution would consider their effects, since they are not forbidden per se. Depending on whether they are regarded as proactive or anti-competitive, the burden of proof should be on the anti-monopoly institution, that is, the economic agent in question.</p> <p>The third type of agreement includes all vertical agreements. These agreements should not be forbidden; instead, they should be subject to reasonable discretionary assessment. The Law must contain an indicative list of these agreements and treat their conclusion as a violation should it be contrary to the Law. The application of the exemption and relief principles or the de minimus rule is implied. All vertical agreements are assumed to be procompetitive, so that the burden of proof would be on the anti-monopoly institution.</p> <p>By making a clear distinction between restrictive agreements, it would be possible to implement an aggressive anti-monopoly policy in the case of horizontal monopoly agreements and a defensive one in the case of vertical agreements.</p> <p>In accordance with EU practice, the notification about agreements would be voluntary. In this way, it would be possible to avoid an enormous administrative burden; costs would be reduced and many technical problems avoided.</p>
<p>Competent Institution</p>	<p>Ministry of Trade, Tourism and Services of the Republic of Serbia</p>
<p>Recommended Time Frame</p>	<p>The new Anti-Monopoly Law should be adopted by mid-2004.</p>

The following matrix contains the recommendations and activities relating to the very important Anti-monopoly Law, which should be implemented by the Ministry of Trade, Tourism and Services of the Republic of Serbia.

Policy Objectives	DEFINING MARKET POWER
<p>Activities Performed To Date</p>	<p>The Ministry of Trade, Tourism and Services of the Republic of Serbia began to prepare a draft of the new Anti-Monopoly Law.</p>
<p>Recommendation/ Remarks</p>	<p>In defining a dominant market position of an enterprise, it would be necessary to include the quantitative aspect of its market share. This criterion would be a necessary but not a sufficient condition for concluding that an economic agent has assumed a dominant market position. In addition to a market share, one should consider other relevant factors, such as: barriers of entry to the market (their strictness, character and duration), potential competition (domestic and foreign),</p>



Policy Objectives	DEFINING MARKET POWER
	<p>market power of buyers, etc.</p> <p>The Law should make a distinction between the abuse of a dominant position, whereby consumers' position is exploited (making an economic profit within a short period) and the abuse resulting in the exclusion or disruption of competition (monopoly pricing, barriers to entry, tied-in sales).</p> <p>It would also be necessary to forbid the abuse of a dominant market position, but not a dominant market position itself. The anti-monopoly institution should not formally monitor economic agents holding a dominant market position, or set up any register to this effect.</p> <p>Like in some countries of Central and Eastern Europe, the indicative cases of the abuse of a dominant market position should be divided into two groups. So, in the case of the abuse of customers' position, the indicative examples would include only the formation of prices which do not reflect the costs and restrictions on production. In the case of restrictions on competition, it would be necessary to consider the formation of prices which do not reflect costs, imposition of barriers of entry to the market, price and other discriminations, as well as tied-in sales.</p> <p>On the basis of the experiences of other countries in transition, it is proposed that the anti-monopoly institution should focus greater attention on the abuse of a dominant market position, whereby competition is restricted or excluded, whereby competition is restricted or excluded, because it has been shown that price control by this institution generates an adverse effect on anti-monopoly policy.</p>
Competent Institution	Ministry of Trade, Tourism and Services of the Republic of Serbia
Recommended Time Frame	The new Anti-Monopoly Law should be adopted by mid-2004.

2.3.5. The Legal and Institutional Framework for the Implementation of Competition Policy

Although Serbia has anti-monopoly regulations and institutions for their enforcement, there is no efficient anti-monopoly policy. Therefore, it is necessary to meet the legal and institutional requirements for its implementation. In that context, it is also necessary to meet another two requirements:

- To achieve institutional independence and
- To establish an efficient and effective legal system.

The Anti-Monopoly Commission of the FRY was set up and started to operate in 1998, in accordance with the federal Anti-Monopoly Law of 1996. However, it was not independent, as is usually the case with the body in charge of competition. Instead, it was sponsored by the for-



mer Federal Ministry of Economy and Domestic Trade against whose decisions it was possible to appeal to the Ministry, which also acted in the name of the Commission in specific cases. In principle, the scope of application of the 1996 Law also included, in principle, the regulation of a dominant market position (a market share of over 25% was regarded as a dominant market position), as well as the regulation of anti-competitive agreements. It is important to note that the current laws and regulations do not govern the procedures relating to the appointment of members of the Anti-Monopoly Commission, their relief of office, reasons for their relief of office, as well as their term of office.

Members of the Anti-Monopoly Commission were often elected from among the ranks of renowned businessmen, thus leading to the conflict of interest. After the adoption of the Constitutional Charter in February 2003, the Anti-Monopoly Commission started to function at the republican level, but since then hardly any decision has been taken in expectation of new regulations.

Policy Objectives	INDEPENDENT ANTI-MONOPOLY INSTITUTION
Activities Performed To Date	The current Anti-Monopoly Commission has been functioning at the republican level since the adoption of the Constitutional Charter.
Recommendations / Remarks	<p>The new anti-monopoly institution should be independent in its work and responsible directly to the Assembly, which appoints and relieves of office its members according to a strict procedure. Members of the anti-monopoly institution should be elected according to the professional criteria, while at the same time taking care that there is no conflict of interest. They should be employed in the anti-monopoly institution on a full-time basis and should not be permitted to engage in other economic activities.</p> <p>The institution authorized to take second-instance decisions should be the trade court.</p> <p>The anti-monopoly institution should have the character of an investigating body. This means that it should decide on applications submitted by other economic agents, and initiate investigations by itself as well.</p> <p>The new institution should be entitled to have access to all relevant data, while at the same time ensuring their secrecy.</p> <p>The institution should be authorized to abrogate specified agreements, forbid the performance of specified activities and impose the payment of fines.</p> <p>The new anti-monopoly institution should observe the principle of openness to the public and periodically submit its reports to the Assembly. To ensure international standardization in this area, the anti-monopoly institution should establish contact with the International Anti-Monopoly Network.</p> <p>The critical factor of the success of the new anti-monopoly institution will be its</p>



Policy Objectives	INDEPENDENT ANTI-MONOPOLY INSTITUTION
	personnel. Thus, it is very important that they are adequately remunerated so as to prevent corruption. It is also necessary to ensure continuing training programmes for members of the anti-monopoly institution, as well as for other employees of this institution.
Competent Institution	Government of the Republic of Serbia and the Ministry of Trade, Tourism and Services of the Republic of Serbia.
Recommended Time Frame	Parallel with the adoption of new anti-monopoly regulations, but not later than the end of 2004.

The current anti-monopoly regulations are concerned exclusively with the effects of monopolistic behaviour and not with its causes or their prevention. Moreover, they are largely non-transparent in view of the fact that this issue is governed by ten or so regulations. Some legal regulations contradict each other, while some legalize monopoly situations in specified sectors. These regulations are also vague in many respects, thus providing the bodies authorized to regulate this issue with substantial discretionary powers.

Bearing mind the hitherto efforts to reform this area, new laws and regulations could be adopted within a relatively short period. In order to approach the EU, while at the same time bearing in mind the forthcoming process of stabilization and association, they should be based on EU experience. New laws and regulations should include a most extensive list of forbidden agreements and types of behaviour, thus leaving minimum scope for discretion.

Despite the fact that there are judicial institutions authorized to regulate this issue, they are, in large measure, not adequately trained and ready to respond to the challenge of competition policy. It is almost impossible to assess their hitherto results, bearing in mind a very small number of the related court proceedings, which is primarily the result of a failure to apply anti-monopoly regulations in the previous period.

Policy Objectives	AN EFFICIENT AND EFFECTIVE LEGAL SYSTEM
Activities Performed To Date	There are specialized commercial (trade) courts which also handle such cases.
Recommendations / Remarks	It is necessary to adopt new anti-monopoly regulations, including all mentioned recommendations. These new regulations should not represent an «original solution», but should be based, above all, on the relevant international standards (EU regulations should serve as a benchmark). New laws and regulations must reduce the degree of uncertainty and vagueness characterizing the current laws and regulations. All anti-monopoly regulations



Policy Objectives	AN EFFICIENT AND EFFECTIVE LEGAL SYSTEM
	<p>should find themselves at one place.</p> <p>New anti-monopoly regulations should generate a strong deterrent effect, based primarily on the imposition of heavy fines for the violation of regulations.⁴⁰</p> <p>It is necessary to organize the training of judges so as to be able to cope with anti-monopoly regulations successfully.</p>
Competent Institution	<p>Ministry of Trade, Tourism and Services of the Republic of Serbia and Ministry of Justice of the Republic of Serbia</p>
Recommended Time Frame	<p>The new Anti-Monopoly Law should be adopted by mid-2004. Judges must be continuously trained.</p>

2.4. Indirect and Direct Taxation

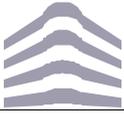
2.4.1. Indirect Taxation

Tax policy represents the symbol of a country's national sovereignty and one of the most important elements of its economic policy. After the establishment of the single EU market, the basic aim of tax policy became the provision of support to the continuous development of the internal market. Thus, there was an increasing need for the harmonization of member countries' tax systems so as to prevent any obstacle to the free movement of goods, services and capital, as well as to competition policy, which can be posed by non-harmonized tax systems. It should be noted, however, that the process of harmonization of tax systems within the EU is rather slow.

The issue of harmonization of tax systems has been explicitly embodied in the Treaty establishing the European Union. Article 90 of the Treaty prohibits any tax discrimination which would, either directly or indirectly, give priority to national products over products from other member countries. The Treaty (Article 93) anticipates the harmonization of the sales tax, excise taxes and other forms of indirect tax. The legal framework for indirect taxation consists primarily of harmonized legislation relating to the value-added tax and excise taxes.

The harmonization of the value-added tax (VAT) was effected in 1977 by replacing all cumulative multi-stage taxes implemented by EU member countries by non-cumulative multi-stage tax. The changes aiming to adjust the value-added tax and excise taxes to the new single market were effected in 1992. These changes were accompanied by partial adjustments of the

⁴⁰There may also be a dilemma as to whether to anticipate criminal responsibility. In our opinion, this option is not good for several reasons. First, criminal proceedings last much longer and require a more complicated procedure for proving the fault. Secondly, EU regulations do not anticipate criminal responsibility (it is not implicitly forbidden). Thirdly, existing anti-monopoly legislation anticipates criminal responsibility, but no criminal proceedings have so far been initiated on such a charge.



rates of these two indirect tax forms, as well as by the agreements establishing closer cooperation between countries.

The basic elements of the EU system of indirect taxation are:

- Value-added tax and
- Excise taxes.

In order to come closer to the European Union, it is necessary to continue with the tax reform in Serbia. At the end of 2000, the tax system in Serbia was in a chaotic state due to which tax reform was initiated at the end of the same year. Otherwise, the reform is conducted in three phases. Within the first two phases, the existing system of indirect taxes was changed so as to increase transparency in the collection of taxes and the improvement of the process including the determination, collection and control of tax revenue. In 2001, the new Law on Excise Taxes was adopted, thus making national legislation closer to EU legislation. First of all, numerous taxes on oil products, cigarettes and alcoholic beverages were combined. Excise products and the system of excise warehouses were harmonized in large measure with the key EU directives.

The essential element of the third phase of tax reform is the introduction of the value-added tax into Serbia's tax system. The introduction of this tax form, which is the pillar of modern market economies, is of great significance both for the process of harmonization with the EU and for better functioning of the domestic tax system. At the moment, the introduction of VAT into the tax system of our economy requires longer and serious preparations. In the coming period it will be necessary to undertake various legislative, institutional and operational measures so as to establish and enable the efficient functioning of the system of value-added tax. One should not allow that the same thing happens again, as many times in the past, i.e. to adopt the Law postponing the implementation of the Law on Value-added Tax for a specified period of time.

Finally, one should bear in mind that harmonization with the EU tax system anticipates the existence and efficient functioning of the basic legal institutions and systems to uphold a market economy, such as: trade law, contract law, application of the international accounting standards, penal legislation, etc.

2.4.1.1. Value-Added Tax

According to Article 93 the Treaty establishing the EU, the harmonization of indirect taxation within the EU consists of the measures that must be implemented so as to ensure the functioning of a single market, prevention of the disruption of competition and removal of obstacles to the free movement of goods and services. For the formation of the internal market, the the system of consumption taxes must be as neutral as possible. The cumulative effect of multi-stage taxes was creating barriers to trade, especially to member countries' mutual imports and



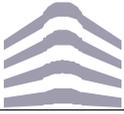
exports, because it was difficult to calculate precisely the share of the tax burden in the prices of products and services. The introduction of the value-added tax (VAT) enabled the transparency of the tax burden at each stage of production and distribution, thus avoiding the cumulative effect of multi-stage taxes and ensuring both national and trading tax neutrality.

VAT was introduced into the European Economic Community in 1970, under the First and Second Directives with a view to replacing the hitherto taxes on production and consumption. The basic part of the relevant EU legislation is Sixth Directive 77/38/EEC on VAT which was, in the meantime, amended a few times (by individual directives). The adoption of this Directive ensured the imposition of tax on the same transactions in all member countries, thus creating a basis for the common tax policy. The Sixth Directive on VAT provides the most important definitions and lays down the principles of value-added tax, while at the same time leaving to member countries to make their choice. The basic principles laid down in this Directive are as follows:

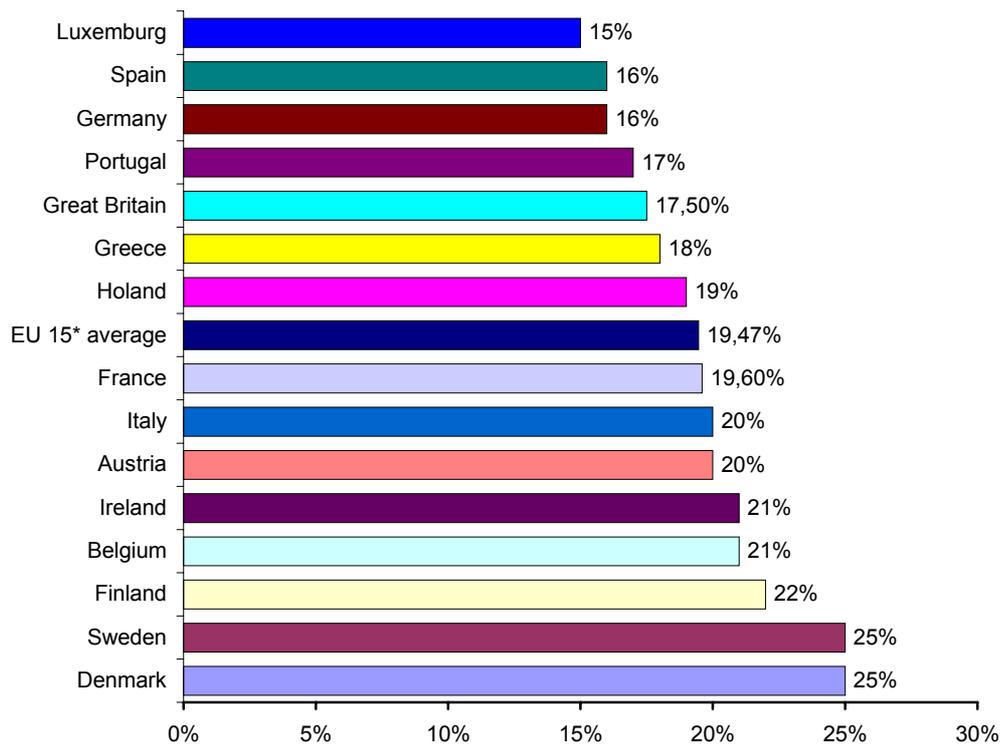
- The imposition of non-cumulative, general value-added tax (VAT), which is distributed at all stages of production and distribution of goods and services;
- Equal tax treatment for domestic and foreign (import) transactions;
- The neutrality principle, which implies that the tax levied on goods and services is in direct proportion to the price, regardless of the number of operations performed in the process of production and distribution prior to the final collection of tax.

The second important step toward the harmonization of the system of value-added tax among EU member countries was the abolition of tax control at the internal borders of the Community (Council Directive 91/680/EEC supplementing the Sixth Directive). In this way, the collection of tax on imports and refund of tax on exports in trade within the Community were discontinued. The implementation of the free movement principle within the Community since 1 January 1993 has terminated the treatment of trade within the EU as import or export transactions.

However, despite considerable work on the harmonization of the system of value-added tax among EU member countries, there are still some differences in this area, which is best illustrated by the data on different VAT rates in member countries.



Graph 2: VAT rates in 15 EU countries



EU legislation in this field keeps changing towards modernization, simplification and an increasingly more uniform approach to the system of value-added tax (emphasis is primarily placed on the equalization of VAT rates and implementation of the principle of taxation based exclusively on the origin of products). In this regard, increasing attention is devoted to cooperation among countries with respect to the collection of taxes and determination of measures for further harmonization.

Over the past ten or so years, all European countries in transition (except Bosnia and Herzegovina and Serbia and Montenegro) have adopted and began to apply the value-added tax. Their experiences show that these countries now have the tax systems which are very similar to those in EU member countries. However, they have not yet been fully harmonized with all regulations specified by the Aquis Communautaire (especially with respect to tax rates, tax refund, tax exemption, etc.). During the process of harmonization, all EU accession candidate countries asked for the implementation of specified transitional measures relating to indirect taxes (value-added tax and excise taxes) on specific goods and services with a view to prolonging harmonization and, thus, lessening its potential social and economic consequences. Such a scenario should also be used by Serbia.

In the first harmonization phase, harmonization with the EU tax system in this area requires the adoption of the appropriate regulations so as to ensure the smooth functioning of the system of value-added tax, in addition to other laws which can be relevant (like those in the areas of trade law, penal law, contract law, as well as the appropriate accounting rules and principles).



To be able to implement the mentioned legislation, it is necessary to create the appropriate institutional basis, including:

- Determination of the VAT seat at the central level;
- Setting up of centres for receiving and processing declarations, as well as for collecting and making payments;
- The establishment of a network of VAT offices at the regional and regional levels;
- Determination of the form and rules for the filing of a tax return and payment of tax on a regular basis;
- Defining the system of sanctions and penalties for non-performance;
- Adoption of the legal procedure for the settlement of disputes between traders and the administration;
- Provision for the investigation of frauds;
- Creation of an information basis for linking the central, regional and local units of the VAT control administration.

It is also necessary to intensify cooperation with other countries in transition which have adopted VAT, as one of the basic preconditions set by the EU for these countries.

In the coming period, within the measures of the first phase of harmonization with EU rules, it is necessary to undertake the following:

- To adopt the Law on Value-Added Tax which will, coupled with the appropriate sublegal enactments, provide a legal basis for the introduction of VAT and which will be harmonized with the EU rules to the extent to which it has been harmonized in other countries in transition;
- To develop the appropriate institutional infrastructure, which should support the introduction and functioning of VAT;
- To launch a broad-based educational campaign so as to educate tax officers and businessmen to work according to the VAT principle.

The mentioned measures form part of the first phase of harmonization with the EU rules. At this moment, it is not necessary to adopt complete EU legislation in this area (that is the aim of the second phase, when all border controls will be abolished). Instead, it should be adjusted to Serbia's economic system so as to establish an efficient, transparent and incentive tax system.

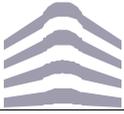


Policy Objectives	INTRODUCTION OF THE VALUE-ADDED TAX INTO THE TAX SYSTEM OF THE REPUBLIC OF SERBIA
Activities Performed To Date	<p>After the adoption of the Law on Tax Procedure and Tax Administration (Official Gazette of the Republic of Serbia, Nos. 80/02, 84/02 and 23/03) the Tax Administration, as the body in charge of tax assessment, collection and control, was set up within the Ministry of Finance and Economy. As on 1 January 2003, after the dissolution of the Bureau for Settlement and Payment Transfers, all control fiscal functions of this institutions were transferred to the Tax Administration, thus eliminating the duality of tax administration and creating conditions for a more efficient control of tax payments, which is one of the basic institutional preconditions for the introduction of an efficient system of value-added tax.</p> <p>According to the same Law, all legal entities and entrepreneurs must register themselves with the Tax Administration on which occasion they obtain their tax identification number without which they cannot open an account in a commercial bank. The register of all taxpayers is kept in the Administration. The Regional Centre for Large Taxpayers was also set up in Belgrade, within the Tax Administration, thus facilitating legal entities falling into this category to meet their their tax liabilities.</p>
Recommendations / Comments	<p>It is necessary to adopt, at the earliest possible date, the Law on Value-Added Tax, which will be harmonized with the basic elements (definitions of taxable person, taxable transaction, place of taxation, collectible event and collectibility of tax, taxable amount, rate-setting principle, basic exemptions, acquisition of the right to tax deduction, persons responsible for payment and their obligations, as well as special regimes of taxation) of the consolidated version⁴¹ of the Sixth Directive on Value-Added Tax. In so doing, one should bear in mind that the Sixth Directive provides scope for countries themselves to adopt appropriate solutions for some parts of legislation (such as, for example, the treatment of capital acquisitions in transport, etc.), which should be implemented in full so as to harmonize legislation with the Yugoslav economic conditions to a maximum. Until the preparation of this report, the preliminary draft of the Law on Value-Added Tax was still not finished, although the work on it has been underway for a longer period. This can bring into question the imposition of this tax as of the beginning of 2005, since considerable time is required for the adoption of this Law and preparation of the basic sublegal enactments, which should regulate this area in greater detail, in addition to having the Tax Administration and taxpayers prepare themselves.</p> <p>In the coming period it will also be necessary to continue with the development of institutional infrastructure, which should support the introduction of the system of value-added tax. Changes in the tax system in the second half of 2002 and early in 2003, which were initiated by the the new Law on Tax Procedure and Tax Administration, should be continued by establishing the VAT seat at the central level and a network of regional offices, thus strengthening the possibilities of the</p>

⁴¹ It includes the original version of the Sixth Directive adopted in 1977, as well as its amendments in the form of directives. Since 1980 there have been 21 such directives.



Policy Objectives	INTRODUCTION OF THE VALUE-ADDED TAX INTO THE TAX SYSTEM OF THE REPUBLIC OF SERBIA
	<p>tax administration for the investigation of frauds. The function of the VAT seat at the central level would be to operate the overall system (and administration) of VAT in the country, as well as to draft and implement all relevant regulations. VAT offices at the regional level (and, later on, at the local one, too) will be in charge of establishing better links of economic entities with the tax administration, including the provision of information to businessmen about their rights and responsibilities, ensuring that businessmen meet their obligations, as well as the checking of the accuracy of data which are submitted by economic agents. In addition, it is necessary to anticipate the establishment of the centre for receiving and processing declarations, as well as for collecting and making payments, which is an integral part of the system of value-added tax in all countries.</p> <p>It is also necessary to continue with the development of information technology, which should create a basis for the establishment of a uniform tax information system, which would link central, regional and local administration units for VAT control, in addition to providing the basis for an efficient introduction and subsequent functioning of the overall VAT system (including future cooperation with the neighbouring countries, as well as with EU member countries).</p> <p>A very important element of the process of introducing VAT in Serbia's tax system should be a broad-based educational campaign among the employed in tax services, as well as businessmen and citizens. The tax administration should be provided with adequate human and technical resources for the adoption and implementation of tax regulations. The employed in the tax administration must be trained to work according to the new tax system so as to facilitate the operation of tax services to a maximum, while at the same time enabling an efficient collection of taxes and control of economic agents. In addition, it is necessary to educate a number of judges who will play a significant role in the settlement of disputes between businessmen and the tax administration. On the other hand, it is also necessary to begin with the broad-based education of businessmen themselves, relating to the significance of VAT, calculation of tax, determination of possible tax exemptions and the right to deduction of a part of tax. In this way, both the tax administration and businessmen will be prepared for the introduction of VAT.</p>
Competent Institution	Ministry of Finance of the Republic of Serbia and the Government of the Republic of Serbia
Recommended Time Frame	<p>The Law on Value-Added Tax should be adopted by July 2004, after which the preparation of sublegal enactments should begin.</p> <p>By the end of 2004, it will be necessary to develop the basic elements of institutional infrastructure, which will support the introduction of the system of value-added tax.</p> <p>By the end of 2004, it will also be necessary to complete the information system, which should provide support to the introduction and functioning of the overall</p>



Policy Objectives	INTRODUCTION OF THE VALUE-ADDED TAX INTO THE TAX SYSTEM OF THE REPUBLIC OF SERBIA
	VAT system. In 2004 and 2005, it will be necessary to continuously conduct an educational campaign among the employed in the tax administration and businessmen.

2.4.1.2. Excise Taxes

The Community's system of excise taxes was introduced on 1 January 1993 with a view to creating the internal market. Excise taxes are levied on three groups of product:

- Mineral oils,
- Cigarettes and tobacco products and
- Alcoholic beverages.

Member countries have the right to retain existing excise taxes, or impose excise taxes on other products, provided that cross-border trade in these products does not require special customs formalities and is in conformity with the Treaty. Free movement of goods is conditioned by the existence of an excise warehouse in which goods can be stored until the payment of excise tax. Such an approach is based on the principle that the excise tax should be paid upon removal of goods from the warehouse, whereby this tax will not be payable if goods are moved from one warehouse to another.

The mentioned goods are liable to the excise tax should they be produced in, or imported from a third country into the territory of a EU member country, whereby excise taxes are paid only after the release of such goods for consumption. The revenue from excise tax belongs to the member country in which these goods are consumed, while the applicable rates are those applied in those member countries. Since member countries apply different excise tax rates on the same products, one of the aims of harmonization is their unification. So far, only minimum rates have been set by agreement.

Harmonization of EU member countries legislations relating to excise taxes was not gradual. So, Community law on excise taxes consists of a set of Directives all of which, except the Directive on cigarettes, were adopted in 1992. The Directives regulate, in greater detail, trends in, and supervision of excise products ((92/12/EEC), harmonization of the excise tax structure (92/81/EEC and 19/83/EEC), as well as the harmonization of excise tax rates (92/79/EEC, 92/82/EEC and 92/84/EEC). In view of the fact that there was no logical sequence in the adoption of these Directives, from the national to the Community level, some of their provisions will have priority in the first phase. Thus, EU accession candidate countries will have to undertake the following measures in the first phase of harmonization:

- To establish the warehouse system and



- To levy tax on the products liable to the excise tax of the Community.

Since 2001, excise taxes in Serbia's tax system have been regulated by the special Law on Excise Taxes. The Law brought about radical changes, thus bringing our legislation closer to the EU standards. So, numerous taxes on oil products, cigarettes and alcoholic beverages have been consolidated. The warehouse system of taxation has also been established. As regards the time of collection and other elements, the system corresponds to the concept of tax warehouses of the Community to the greatest extent. The Law also stipulates the procedure for the issuing of licences for excise warehouses, but it has not been harmonized with the EU Directives in full. The structure of excise taxes has also been harmonized, with the exception of excise taxes on ethyl alcohol, alcoholic beverages and oil products. The further harmonization of the structure, that is, the identification of the same products within the groups of products liable to excise tax is also important, because all national industries adjust their production to maximum tax efficiency. Gradual harmonization with the Community excise tax structure will ensure the competitiveness of the domestic industry upon after the accession to the EU.

All excise taxes, except the excise tax on luxurious items, are given in absolute terms, whereby the dinar amounts are adjusted to the rate of a retail price increase on a quarterly basis. The group of excise products has been enlarged by table salt and some hitherto untaxed oil products, non-alcoholic beverages and bottled water. The novelty relating to the imposition of excise taxes on consumption is also the introduction of specific excise taxes. Underway is the preparation of a long-term strategy of Serbia's excise policy which anticipates full harmonization with the EU Directives and WTO standards with respect to:

- Excise warehouses,
- Excise tax structure and
- Excise tax rates.

Policy Objectives	HARMONIZATION OF THE STRUCTURE AND AMOUNT OF EXCISE TAXES WITH THE EU DIRECTIVES
Activities Performed To Date	The Law on Excise Taxes, which was adopted in 2001, has been mostly harmonized with the EU standards. Excise products correspond to excise products that have been jointly identified as such for EU member countries (oil products, tobacco products, and ethyl alcohol and alcoholic beverages). The established warehouse system of taxation has been adjusted to the EU system of excise warehouses. The excise tax on exported products is paid in the importing country at the rate applied in that country.
Recommendations / Comments	As for excise warehouses, it is necessary to harmonize the procedure of obtaining a licence for operating a excise warehouse. The existing procedure deviates from the one prescribed in the EU.



	<p>It is necessary to harmonize the structure of excise taxes on ethyl alcohol, alcoholic beverages and oil products with the EU requirements in full. This will ensure the competitiveness of the national industry after the country's accession to the EU and introduction of the new excise tax structure relative to imported goods.</p> <p>Deviations from the EU requirements are especially evident in the case of excise tax rates. Thus, their dynamic harmonization with the EU Directives is required within the period of a few years. The plan should specifically cover excise tax rates on oil products and cigarettes which are, at the moment, lower than the prescribed ones.</p> <p>Excise taxes on oil products in Serbia are lower than in EU countries. The greatest difference is recorded with respect to the taxation of diesel oil on which the minimum excise tax in the EU is 245 EUR/hl. In accordance with the EU Directives, it is also necessary to increase the tax on leaded petrol and introduce specified concessions for the use of especially designated diesel oil in agriculture and fishing industry. There are also great differences in the amount of excise taxes on jet aircraft fuel and aircraft engine petrol for which the minimum rate in the EU is 245 EUR/hl.</p> <p>The harmonization of excise taxes on cigarettes would include harmonization with the requirements that the excise tax on the best-selling brand of cigarettes should be at least 57% of its retail price, including all taxes (Directives 92/79/EEC and 99/81/CE). The excise tax on cigarettes is calculated by using a special method (per unit of product, that is, per 1,000 cigarettes), as well as the proportional method (ad valorem, considering the maximum retail price). Member countries can choose only the proportional or special calculation method, as well as the combination of the two.</p> <p>For determining the amount of specified excise taxes it is necessary to take into account environmental and health aspects, as well as the interest of the domestic industry.</p>
Competent Institution	Ministry of Finance of the Republic of Serbia
Recommended Time Frame	The Law on Excise Taxes should be amended by mid-2004.

2.4.2. Direct Taxation

In SM's tax system, direct taxes include the profit tax, income tax and property tax. In the European classification system, those are the corporate income tax, capital duty and personal income tax.



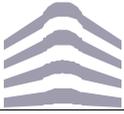
The main objective of the EU's tax policy is to spur the development of the internal market or, more precisely, to pursue the so-called four freedoms (free movement of people, goods, capital and services), which have been already proclaimed under the Treaty of Rome. To attain this objective, efforts are being made towards the harmonization of member countries' tax systems.

However, the hitherto results relating to the harmonization of direct taxes, at the level of EU member countries, are still modest. As for the income tax, harmonization of coordination are not necessary, since member countries are left to regular their income tax by themselves, provided that they do not affect the fundamental principles of the common market (free movement of goods, people, services and capital). Better results have been achieved in the harmonization of the profit tax and capital duty.

The adoption of a modern tax system and structural tax adjustments are one of the preconditions for the formation of the internal market and SM's accession to the EU. Two basic Directives, whose provisions should be incorporated into national legislation in the first phase of accession to the EU are: Directive 77/799/EC relating to mutual assistance in direct and indirect taxation and Directive 69/335/EC on capital duty. One should also take into account two recommendations in the field of direct taxation: on the taxation of specified kinds of non-resident income (94/79/EC) and on the taxation of small and medium-sized enterprises (94/390/EC).

The Directive on mutual assistance indirect taxation anticipates the exchange of information between the competent bodies of member countries, which are important for a correct assessment of the income tax and capital duty. The tax administration of one member country submits information to another member country at its request, or automatically, without prior request, in case that such information is of special significance for the prevention of tax evasion. Such a situation emerges when there is a well-founded suspicion that profit transfers within transnational companies may lead to the avoidance of paying the profit tax. The exchange of information is limited only if the disclosure of certain data would endanger the business secret of the enterprise concern. Cooperation between national tax administrations is carried out mostly under bilateral tax agreements.

The Directive on Capital Duty regulates the transactions, bases and rates at which the capital duty is paid. The payers of the capital duty are open capital companies which are registered or have the effective centre of management and control in the territory of a member country. The capital duty is paid on: initial capital, capital increase by increasing the share or capitalizing the profit, transformation of close companies into open ones, as well as long-term debt financing if the creditor has the right to profit-sharing. Under this Directive, the rate at which the capital duty is paid, on the base which is the value of the capital being invested, owned or transferred, must not be higher than 2% or lower than 1%.



Tax reform in Serbia was initiated in 2001 with a view to making the tax system neutral and transparent. The second-wave reforms were carried out in the autumn of 2002, introducing a number of incentives to employment and investment, including the lowering of the rate of the corporate income tax to 14% and the rate of the annual tax on personal income to 10%.

The payers of the profit tax are legal entities, residents and non-residents of the Republic of Serbia. Residents are liable to pay tax on the profit earned in the territory of the Republic of Serbia and abroad. The status of a resident taxpayer is acquired by every legal entity that has been formed, or has the effective centre of management and control in the territory of Serbia. Non-resident taxpayers are liable to pay tax on the profit earned in the territory of Serbia. Non-residents are liable to pay tax on the profit earned by transacting business through their permanent operating unit (a branch, plant, factor, representative office, mine, etc.), which is located in the territory of Serbia. The profit tax is paid at the flat rate of 14%. The tax on dividends and shares in the profit in a legal entity, as well as on royalties and interest earned by a non-resident is paid at the rate of 20%. The interest and related costs arising from the loan granted to the permanent operating unit by its non-resident centre are not recognized as expenditures in the tax report of the permanent operating unit. All operating losses, shown in the tax report, can be carried forward and offset against the profit in the tax report for the limited period of ten years. In Serbia, the capital gains tax and avoidance of double taxation are also regulated by law. SM has signed the Double Taxation Agreement with most European countries. The new legal solutions have introduced more stringent requirements for tax consolidation in view of the fact that, within the group of enterprise, the gain of one enterprise can be offset by the loss of another, thus achieving a significant tax concession.

Since the overriding objective of the EU is the long-term lessening of the tax burden, it can be stated that Serbia's economic policy is moving just in that direction. The rate of the profit tax is 14% (it is expected that it will soon be lowered to 10%). There is also a wide range of tax incentives to capital investment, which is in conformity with development and foreign capital attraction policy. However, the picture about a low profit tax can be blurred by the fact that there are many local taxes that must be paid by enterprises, such as: the municipal land tax, business naming fee, environmental tax, etc. In that sense, the simplification of various taxes of this kind is desirable. In the first phase of accession to the EU, it is also necessary to incorporate the recommendations relating to the capital duty into our legal solutions. In the Serbian tax system, an equivalent to the capital duty is the property tax. As stipulated by law, legal entities and physical persons pay tax on the title to real estate at the rate of 0.40%, assessed on the base which is the book value of that real estate, determined on 31 December of the previous year. The property tax is also paid on the ownership right to: 1) registered shares and 2) stakes in a limited liability company. The payers of this tax are legal entities and physical persons – residents of the Republic of Serbia who hold that right, at the rate of 0.25%. The property tax base for registered shares and stakes in a limited liability company if the taxpayer is a legal entity, is the book value as on 31 December of the year preceding the year for which the

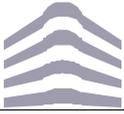


property tax is assessed and paid. If the taxpayer is a physical person, the property tax base is the value of his capital as on 31 December of the year preceding the year for which the property tax is assessed and paid, based on the data of the legal entity in which the taxpayer owns capital, which are, at the owner's request, confirmed in writing by that legal entity. Under the EU Directive on the capital duty, capital should be taxed at the rate which does not exceed 2%, or is lower than 1%.

So far, several significant changes have been effected towards the adoption of a synthetic approach to the income tax. So, the gross wage concept has been introduced with a view to integrating all receipts of the employed arising from his employment into the wage (i.e. the wage based on the cost of labour, allowances, holiday bonus, numerous wage supplements and obligations arising from taxes and contributions on his wage). Also, the burden has been significantly reduced by lowering the rates of social insurance contributions.

The tax rate on personal income is 20%, except in the case of the wage tax, income from agriculture and forestry and income from self-employment, where the prescribed rate is 14%. The personal income tax is levied on the following types of income generated during the calendar year: (15) a) wages, b) income from agriculture and forestry, c) income from self-employment, d) income from copyrights and industrial property rights, e) yield on capital, f) income from real property, g) capital gains, i) other types of income (leasing of equipment, gambling gains, income from personal insurance, etc.). Under the arrangement with the IMF, it is anticipated that the existing tax on total personal income should be replaced by a synthetic tax by 2005.

Policy Objectives	HARMONIZATION OF THE SYSTEM OF DIRECT TAXES WITH EU LEGISLATION
Activities Performed To Date	<p>The tax reform in Serbia was initiated in 2001 with a view to making the tax system neutral and transparent. The second-wave reforms were carried out in the autumn of 2002, introducing a number of employment and investment incentives, including the lowering of the rate of the corporate income tax to 14% and the rate of the annual tax on personal income to 10%.</p> <p>As for the income tax, the gross wage concept was introduced, which is a step towards adopting a synthetic approach to income tax.</p>
Recommendations / Comments	<p>To impose a synthetic tax on personal income. The tax base should include all types of earned income (temporary service contracts, royalties, etc.), thus enlarging the tax base.</p> <p>To reform the corporate income tax and property tax by incorporating the recommendations from the Directive on capital duty, which stipulates that the rate of capital duty must not exceed 2% or be lower than 1%. It is also necessary to define the specified terms in the Law on Property Tax more precisely. So, for example, the Law stipulates the payment of duty on the capital owned in the form of registered shares, which is not in conformity with EU regulations, because this</p>



Policy Objectives	HARMONIZATION OF THE SYSTEM OF DIRECT TAXES WITH EU LEGISLATION
	type of share is not mentioned. It is necessary to establish cooperation with EU member countries' tax administrations under bilateral agreements.
Competent Institution	Ministry of Finance of the Republic of Serbia
Recommended Time Frame	During 2004

2.5. Financial Services

One of the ideas underlying the conclusion of the Treaty of Rome establishing the European Economic Community in 1957 was the creation of a single market which would, apart from fair competition, have all characteristics of a domestic market. To materialize the idea about the free movement of goods, services and people and capital through the founding countries of the EEC (EU, later on), as well as through other member countries by the subsequent process of enlargement, it was necessary to initiate the process of harmonization of fiscal policy, monetary policy foreign trade and all other sphere of economic policy implemented by EU member countries. In this regard, the harmonization of the financial systems of member countries and potential candidates for accession to the EU represented an especially sensitive issue, which was raised in 1971 by presenting the idea about the formation of the European Monetary Union in the so-called Werner report.

A developed financial system, through the mobilization and allocation of financial resources to the most-productive investments, coupled with the diversification, transfer and trade in risks, provides a basis for the functioning of a market economy and its long-term development."A well-developed financial system provides a basis for the functioning of a market economy and its long-term development through the mobilization and allocation of financial resources to the most productive investments, coupled with risk diversification, transfer and trading. Different studies point to a positive correlation between the quality of the financial sector and the rate of economic growth." (16) The foundation of every market economy, as well as successful transformation of a centrally planned economy into a market one, is a well-developed financial sector. Namely, long-term economic development is not possible without an efficient financial services sector, which is largely based on confidence. The key to the development of such a financial system is the protection of creditors' interests, adoption of a set of efficient and harmonized laws, as well as the upgrading of, and respect for the work of supervisory bodies.

Since all founding countries of the EU had relatively developed financial systems at the moment of its formation, the coordination of financial sectors was not aimed at developing a new



financial system, but at improving national financial systems by harmonizing the minimum requirements for specified financial institutions so as to lay down the minimum common standards and develop a single financial services market. Therefore, the harmonization of supervisory activities vis-à-vis institutions providing financial services has become the main objective of EU member countries, thus enabling the mutual recognition of the authority and system of prudential supervision over financial institutions among these countries. On the other hand, financial services of centrally planned economies were laid on absolutely different foundations relative to those in market economies. After the beginning of the process of transformation of these economies into market-based ones, their inclusion in European integration was becoming increasingly more realistic. Thus, it turned out that financial services in those countries should also meet the minimum requirements so as to reduce significant global differences in the structure, operation and supervision of the financial services sector. "The reform of the financial sector should be carried out in three directions (19):

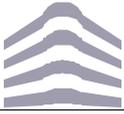
- a) Restructuring of the banking sector
- b) Development of the capital market and
- c) Formation of non-existent institutions"

Banking Sector

Banking institutions are traditional participants in the financial market or, in other words, typical financial intermediaries in all European market economies. Their basic role is to collect free financial resources in the form of deposits and invest them in the form of credit granted to enterprises and individuals. As the key financial intermediaries in most European countries, they are of special significance for the economies in transition where, due to an underdeveloped capital markets or alternative sources of financing, the banking sector is a dominant intermediary in the acquisition of missing capital.

However, due to differences in the development level of the banking sector among EU member countries and especially among countries candidates for accession to the EU, at the EU level and in the context of further integration, the phases of banking sector development have been established and presented through EU Directives. Before making reference to EU Directives, which regulate the banking sector, it is important to note that the sequence in which the EU Directives governing the overall financial system were adopted, does not reflect the chronological sequence of their implementation, because the sequence in which Directives are adopted depends primarily on the development of the financial system. In that context, EU Directives, which fall within the first phase of financial sector development in the field of banking are as follows:

- First Directive 77/780/EEC on banking stipulates the freedom to establish and provide banking services. The Directive regulates the procedure for the submission of applications for the formation and operation of credit institutions, including the minimum



amount of own resources, necessary personnel for the management of credit institutions, their reputation and experience in such activities, etc.;

- Directive 89/299/EEC on own resources defines the elements of the capital of credit institutions, specifying the structure of their original and additional capital, as well as the ratio between these two types of capital;
- Directive 89/647/EEC on solvency is aimed at harmonizing supervision over the activities of credit institutions, as well as strengthening the standards relating to the solvency of credit institutions within the EU). The Directive directly reflects the international obligations of the banking sector established under the Basel Agreement of 1988;
- Directive 94/19/EC on deposit guarantee introduces the compulsory deposit guarantee scheme into the sector of credit institutions. Its basic role is to build the confidence of depositors in the activities of credit institutions. The minimum amount of of guaranteed deposit is €20,000, which is paid in the case of insolvency of the credit–deposit institution.

As the result of numerous amendments, the mentioned three Directives were consolidated and replaced by 2000/12/EC which sets the minimum requirements for the formation and operation of credit institutions in a consistent way.

Securities Market

In industrialized European countries, the securities market has a rich historical background. Europe is the cradle of stock–exchange business, so that it has centuries–long experience with transactions in securities. However, the tradition of dealing in securities is not universal, bearing in mind different approaches of Anglo–Saxon, Germanic and Romance tradition.

However, since the financing of economic development through transactions in securities represents a much more progressive form of credit–financial relations relative to traditional ones, and inclusion in European integration calls for the promotion of this form of financing, countries candidates for membership in the EU will have to devote special attention to the implementation of the principles laid down in the following EU Directives, in the first phase of harmonization of their securities sector:

- Directive 89/298/EEC on the prospectus refers to the coordination of activities within the preparation, consideration and distribution of the prospectus, as the most important document for the openness to the public of enterprises whose securities are traded in the market. This Directive practically unifies the basic elements of the prospectus, which will guarantee a realistic financial assessment of securities by investors. It is also stipulated to appoint a special supervisory body within the government which will consider and approve the distribution of prospectuses. At the same time, the observance of the provisions of this Directive enables mutual recognition of prospectuses in the



situation when securities are offered on stock exchanges of more than one EU member country;

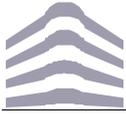
- Directive 79/279/EEC on obtaining listing on the stock exchange sets the requirements which a security must satisfy so as to be placed on the listing of the stock exchange and be quoted on the market. Its provisions also stipulate the formation of the body authorized to decide on the inclusion of a security in the stock exchange. It also specifies the basic elements of cooperation among member countries required for cooperation between member countries with respect to listing;
- Directive 88/627/EEC on reporting majority shareholding is aimed at ensuring the provision of impartial information to investors about the ownership structure of the enterprise in whose securities they are interested. Namely, the provisions of this Directive stipulate that the enterprise should always inform the public whenever the voting right of a person declines or exceeds the limit of 10%, 20%, 33%, 50% or 66%. The competent authorities in the country may relieve an enterprise of this obligation only if they conclude that the disclosure of such information may seriously affect the enterprise in question;
- Directive 89/592/EEC on internal rules regulates dealing in securities within connected enterprises, that is, the use of so-called insider information. The basic aim of the Directive is to protect investors from the abuse of internal information, that is, to assure investors that they will enjoy equal treatment on the market.

The mentioned four Directives have been consolidated into Directive 2001/23/EC, coupled with the adoption of specified amendments. On 12 April 2003, the Directive on internal rules was replaced by Directive 2003/6/EC.

Investment Funds

At a specified level of development and regulation of the securities market there appear new participants in the financial market – institutional investors. These financial investors operate on the basis of the resources of a large number of small investors through the sale of securities and investment of the proceeds into new securities. This stimulates investment by small investors whose resources, taken as a whole, represent a great financial potential. Small investors opt for such a form of investment due to considerably lower investment costs and diversified investment opportunities which, otherwise, would not be accessible to them if they appear on the market on their own.

These institutions are much more present in industrialized European countries than in countries in transition in which, depending on the development level of their capital market, the presence of investment funds is at a much lower level. However, bearing in mind the significance of these institutions in the absorption of the money hoarded by individual small investors, it is not surprising that EU accession candidate countries are taking effort to provide access to their fi-



financial markets to the greatest possible number of institutional investors. To that end, they observe the provisions of the Directive on Undertakings for Collective Investment in Transferable Securities (UCITS 85/611/EEC), which lays down the principles for the formation of investment funds, rules for the sale and purchase of their units, investment rules for investment funds, formation of the bodies authorized to issue operating licences, monitor and supervise the operation of these funds, etc.

In addition to the mentioned Directives, which regulate the harmonization of operations of credit institutions, securities market and investment funds, the Directive on Money Laundering (91/308/EEC) covers all three areas at the same time. This Directive, which was later supplemented by Directive 2001/97/EC, prohibits the use of the financial system for the purpose of money laundering, which is closely related to criminal activities and tax evasion. Without these measures, and due to the loss of confidence in financial institutions, the overall financial system would be endangered. Therefore, it is very important that the countries which embarked on the road to integration into the EU should implement the provisions of this so-called »horizontal Directive« as much as possible.

In Serbia, in the area of financial sector, as well as in the financial system in general, some progress has been made over the past three years. Reforms within the financial sector have been directed towards the reform of the monetary system, restructuring of the banking system and the recovery and development of the financial market.

As the result of the hitherto activities, macroeconomic and monetary stability has been achieved and confidence in existing financial institutions and national currency has been restored. From the viewpoint of harmonization, which is required for European integration, the banking sector in Serbia has made the greatest progress. So, in harmonization with the EU rules this sector has so far made the greatest progress as opposed to the domestic securities market, or investment funds which are still not present on the domestic financial market. Due to such a situation in Serbia, and in order to adopt the provisions under which the financial services sector is regulated within the EU, it is necessary to continue with the activities directed to:

- Further harmonization of the operation of credit institutions with the relevant EU provisions;
- Increased transparency of public offering and protection of investors' interests in financial-market operations;
- Encouraging the establishment of the hitherto non-existent financial institutions and the provision of new financial services, and
- Intensification of the activities against money laundering.



Policy Objectives	1. FURTHER HARMONIZATION OF THE OPERATION OF CREDIT INSTITUTIONS WITH THE EU PROVISIONS
<p>Activities Performed To Date</p>	<p>The standards, which banks must meet and which have largely been harmonized with the standards laid down in Directive 2000/12/EC, have been stipulated pursuant to the Decision on Particular Conditions for the Implementation of Articles 26 and 27 of the Law on Banks and Other Financial Institutions (Official Gazette of the FRY, No. 39/02). Deviations from the EU standards are observed with the minimum of initial capital requirement for bank, which has been increased to €10 million in the dinar equivalent in our country. Also, the indicator of the total amount of large and the largest possible credits which a bank can grant at the EU level is 800%, while the domestic legislator set the limit of 400% of a bank's total capital.</p> <p>Considering the prescribed structure of total capital, i.e. original and additional capital, it can be stated that it has been fully harmonized with the EU standards.</p> <p>The Law on the Agency for Deposit Insurance, Rehabilitation, Bankruptcy and Winding-up of Banks stipulates the introduction of the deposit guarantee system. The Law also stipulates that deposit insurance comes within the competence of the Agency, while all banks are obliged, pursuant to the still enforceable decision of the NBY on the types and amounts of bank deposits which are guaranteed by the Agency (Official Gazette of the FRY, NO. 22/94), to insure deposits of private individuals up to the amount of 5,000 dinars per depositor, regardless of the type and number of deposits kept by the depositor in a bank.</p> <p>One of the areas on which it is especially insisted within the EU Directives, refers to the improvement of the efficiency of supervisory bodies and their greater mutual competitiveness and cooperation. In the context of harmonization with the EU rules, the NBS has undertaken the following steps towards strengthening supervision over credit institutions: the Department for Problem Banks has been set up, while the Law Amending the Law on the Agency for Deposit Insurance, Rehabilitation, Bankruptcy and Winding up of Banks stipulates that the Agency should be in charge of banks undergoing bankruptcy proceedings or rehabilitation. The NBS also adopted the Development Plan for the control function in the period from November 2002 to December 2005, anticipating the concept of banking supervision based on risk control. According to this Plan, the control function includes: a) off-site and on-site supervision; b) implementation of remedial measures vis-à-vis banks; c) issuing of the prescribed licences and approvals, and the preparation of legal solutions; d) cooperation with other control institutions. The control function will be based on the fundamental principles of the Basle Committee on Banking Supervision for control function will be based on the basic principles of the Basle Committee for Bank Supervision, including the use of the CAEL and CAMEL criteria for the ranking of banks. New provisions have also been adopted, whereby banks are obliged to establish adequate systems of internal control and internal audit.</p>
	<p>The procedure of issuing licences for the formation and operation of credit institutions does not differ much from the First Directive on banking. From the view-</p>



Policy Objectives	1. FURTHER HARMONIZATION OF THE OPERATION OF CREDIT INSTITUTIONS WITH THE EU PROVISIONS
<p>Recommendations / Comments</p>	<p>point of domestic (Serbian) banks, the procedure is transparent, but the problem arises with respect to the mutual (non)recognition of licences for the formation and operation of credit institutions at the level of the State Union, on which the EU insists. In addition to the existence of two separate monetary systems, different banking and other regulations governing the functioning of the capital market, non-recognition of a compromise in inter-republic payment operations and the non-existence of an agreement on the legal solutions regulating the capital market, non-recognition of a compromise in inter-Republic payment operations, as well as the non-existence of an agreement on the mutual recognition of licences in the State Union pose a serious obstacle to free business operations and provision of financial services. For the purpose of harmonization with the EU rules and upgrading the financial services system in the country, it is necessary to overcome these problems and ensure the smooth performance of financial activities.</p> <p>Insofar as the establishment of a credit institution by a foreign legal or physical persons is concerned, the Law stipulates that a foreign bank can set up its branch with the status of a legal person (affiliate) and its representative office, which will engage only in financial market research and preliminary activities concerning the conclusion of contracts and presentation of the foreign bank. According to the regulations, it is prohibited to set up an operating unit, that is, an affiliate of a foreign bank without the status of a legal entity. In this respect, national legislation is more restrictive than the EU provisions (Article 20, Directive 2000/12/EC).</p> <p>A deviation from the minimum of initial capital requirement for banks specified by the EU rules arises from the need for consolidation of the banking sector and the formation of really capitalized banking groups, which will be able to pay out their clients. After the creation of a sound banking sector, it is recommended to return the minimum of initial capital requirement to the level set by the EU.</p> <p>The total amount of big and the biggest possible credits that a bank has not been harmonized either. At the EU level, this indicator is 800%, while in Serbia it is twice as small. Despite being contrary to the harmonization requirements, this indicator should not be changed before a satisfactory financial discipline is established in the domestic economy.</p> <p>In the area of banking supervision, it is also necessary to strengthen and develop the monitoring function still further so as to ensure preventive and/or subsequent banking supervision, as well as to receive feedback from banks themselves, thus improving the current laws and regulations. For the purpose of harmonization with the EU rules, it is especially important to promote cooperation in the supervision of credit institutions with the competent bodies of other countries (in 2002, such agreements were concluded with the central banks of Greece and Cyprus).</p> <p>The deposit insurance scheme has not yet become operative in full. The procedure of deposit insurance, as a very delicate and strategically important activity, should be removed from the Agency for Deposit Insurance, Rehabilitation, Bankruptcy and Winding up of Banks, bearing in mind that EU practice confirms that</p>



Policy Objectives	1. FURTHER HARMONIZATION OF THE OPERATION OF CREDIT INSTITUTIONS WITH THE EU PROVISIONS
	<p>this mechanism is operated by independent institutions to which this is the only activity. It is not realistic to expect that one Agency will be able to successfully perform so many important activities at the same time. It is necessary to increase the level of deposits that will be insured, but in the transitional period, for setting the new level, it is necessary to take into account the existing structure of the deposit potential of domestic credit institutions. The proposed level is €5,000. With the further strengthening of the financial sector and increase in the level of economic activity and the standard of living (which will then increase the level of deposited funds), one should shift to full harmonization with the provisions of the EU Directive (the level for deposit insurance in the EU is €20,000).</p> <p>The method of determining premiums which banks have to pay for the deposit insurance service is in conformity with the EU standards (the method of adjusting the amount of premium to the degree of risk to which the Agency is exposed in the specified bank). However, after the expiration of the transitional period, it is necessary to prescribe the financing of the Agency which is based exclusively on collected premiums, while at the same time eliminating donations from the budget.</p>
Responsible Institution	National Bank of Serbia, Agency for Deposit Insurance, Rehabilitation, Bankruptcy and Winding up of Banks, Government of the Republic of Serbia
Time Frame	<p>The activities relating to the harmonization of the monetary systems, different banking and other provisions regulating the operation of credit institutions, inter-republic payment operations, as well as the mutual recognition of licences for the formation and operation of credit institutions within the State Union should be continued until all problems in this area are solved.</p> <p>The activities relating to the strengthening of banking supervision and cooperation among countries at the level of supervisory bodies should be continuously performed.</p>

The reform of the financial market in Serbia began with the formulation of the appropriate laws and establishment of an adequate institutional framework, thus meeting the preconditions for the revival of the capital-raising process and efficient allocation of savings. In large measure, the revival of the activities on the stock exchange has also been contributed by the adoption of the new Privatization Law (Official Gazette of the FRY, Nos. 38/01 and 18/03), which introduced public tender and auction as the basic methods of conducting the privatization process. This was followed by the adoption of the new Securities Law, which introduced numerous novelties (mostly harmonized with the EU Directives) relative to the hitherto regulations governing the functioning of the financial market. However, it has some deficiencies which must be eliminated within the shortest possible time so as to ensure the further development of the financial market.



<p>Policy Objectives</p>	<p>2. FURTHER IMPROVEMENT OF THE TRANSPARENCY OF PUBLIC OFFERING AND THE PROTECTION OF INVESTORS ON THE FINANCIAL MARKET</p>
<p>Activities Planned And Performed To Date</p>	<p>The Law on the Securities Market was adopted at the end of 2002 and came into force on 1 October 2003, thus superseding the Law on Stock Exchanges, Stock–Exchange Intermediaries and Stock–Exchange Business, as well as the Securities Law. The basic novelties include the regulation of, and insistence on the transparency of public offering, increased transparency of the functioning of the securities market, greater protection of investors, independence of the Securities Commission (Agency), as well as the adoption of some new market instruments (warrants, futures and options).</p> <p>In accordance with the Law, the Securities Commission adopted the Rules on the content and form of the prospectus and other documents which are submitted for the purpose of securities distribution. In accordance with the relevant EU Directive, the content of the prospectus accompanying security issue has been enlarged, while the selling procedure has been formalized. In this way it is attempted to increase the transparency of information when a new security issue is announced, thus ensuring symmetric information and decreasing the possibility of abuse.</p> <p>The EU Directive on reporting majority shareholding has been observed by incorporating its norms into the Law and by adopting the special Rules on the obligation to inform the Commission about the cases of acquiring (or losing) a share in the capital of a company of 10%, 20%, 33%, 50% and 66%.</p> <p>Harmonization with the EU Directive on internal rules has been ensured by defining the notion of privileged information and insider trading. Those having confidential information are allowed to trade in securities, subject to the pre–notification of the issuer, Securities Commission and the stock exchange on which securities are quoted.</p> <p>Insofar as the procedure relating to the listing and quotation of securities on a regulated market is concerned, the procedure of receiving securities on the listing of the Stock Exchange is conducted in conformity with the Rules on the Quotation of Securities on the Belgrade Stock Exchange, Rules on Trading in Privatization Shares and the Rules on Secondary Trading in Long–Dated Debt Securities. As for long–dated debt securities which are issued by a constituent republic or the central bank, they do not undergo any special procedure for obtaining a listing on the Stock Exchange. The very submission of an application for listing is regarded as such. As for the issuers of privatization shares, it is anticipated that their shares will be received on the market after enclosing the verified Prospectus and the certificate of conformity of the status in the Shareholders' Register with the data base in the Provisional Register. So far, share issue for the purpose of recapitalization has not been carried out through listing of the stock exchange, because it is the question of private placement arrangements.</p> <p>The Securities Law stipulates the formation of the Central Register, custody and clearing of securities. This uniform register began officially to operate at the beginning of 2004. The introduction of this register into the financial system in Serbia will greatly increase investors' security and protection of their rights, because</p>



<p>Policy Objectives</p>	<p>2. FURTHER IMPROVEMENT OF THE TRANSPARENCY OF PUBLIC OFFERING AND THE PROTECTION OF INVESTORS ON THE FINANCIAL MARKET</p>
	<p>all transactions in securities will be carried out in public, coupled with compulsory registration in the Central Register.</p>
<p>Recommendations / Comments</p>	<p>Parallel to the development of trading in securities, it will be necessary to stiffen the criteria for the acceptance of a security on the official listing of the stock exchange and its quotation on a regulated market so as to ensure the greater protection of investors, as well as issuers themselves. Until then it will be necessary to solve the problem of asymmetric information, which is still present despite the legislator's efforts to alleviate it by regulations. Namely, although this is their obligation under the relevant laws and regulations and the Rules of the Belgrade Stock Exchange, enterprises either do not publish their financial reports, or do that on rare occasions. Such a situation is further aggravated by the fact that there are still no institutions which will force enterprises whose shares are traded on the Stock Exchange to publish their financial indicators. Therefore, it is necessary to intensify the activities of the Securities and Exchanges Commission within its supervisory function.</p> <p>Although insider trading has been defined by the Securities Law, the solving of this problem has not been sufficiently institutionalized. Namely, the identification of such cases comes within the competence of the Securities Commission and the stock exchange. However, these two institutions are still not capable to do that, nor do they have enough personnel trained for the preliminary identification of the cases of insider (unjust) trading and solving of this problem. There are also some other problems, which are related primarily to the shortcomings of existing regulations. So, for example, there are no provisions defining the notion of connected enterprises. Thus, it is still possible that one person is, at the same time, the owner of the enterprise whose shares are traded, the owner of the brokerage firm through which those shares are traded and the owner of the auditing firm that will subsequently perform the audit of the balance sheet of that enterprise. The abuse of information is possible just in such situations. Therefore, the new Companies Law (whose draft has been prepared) should solve this collision with the provisions of the Law on the Securities Market, while at the same time intensifying the efforts towards the preliminary identification of insider trading.</p> <p>The central register, custody and clearing of securities became operative at the beginning of 2004. Thus, until their full operationalization it is necessary to clarify numerous issues that have not been defined by the Law on the Securities Market, such as: 1) ownership of the Central Register of Securities, which has been defined as a joint-stock company, with the minimum share of state capital of 51%, while in European practice the Central Register is an independent institution; 2) the level of guarantees that should be adopted so as to increase the security of Register members; 3) establishment of the treasury and compensation funds within the Central Register of Securities; 4) method risk insurance; 5) regional links with other securities registers in the neighbourhood (cross-border services), etc. The original capital of €50,000 is too small to ensure the function-</p>



Policy Objectives	2. FURTHER IMPROVEMENT OF THE TRANSPARENCY OF PUBLIC OFFERING AND THE PROTECTION OF INVESTORS ON THE FINANCIAL MARKET
	<p>ing of such an institution, so that original capital should be increased. The experiences of other European countries point to the separate formation of the institution in charge of securities custody from that whose activities include the settlement and clearing of securities. Therefore, it is necessary to consider the use of such a mechanism in domestic practice.</p> <p>In the coming period it will be necessary to intensify the processes of linking the domestic financial market with the markets in the region, thus contributing in large measure to a reduction in transaction costs, increased transparency and liquidity of the market, as well as the increased interest of foreign investors in domestic securities.</p>
Responsible Institution	National Bank of Serbia, Securities Commission and Belgrade Stock Exchange
Time Frame	<p>Improvement of efficiency in the work of the relevant supervisory bodies and the intensification of the fight against insider trading – continuously.</p> <p>Resolving the moot questions concerning the functioning of the Central Register – mid-2004.</p>

At the moment, there are no investment funds in Serbia due to the absence of the relevant laws and regulations, undersupply of high-quality securities, as well as an inadequate information base concerning the performance and credit rating of enterprises operating on the domestic market. As for other domestic financial institutions (insurance companies and pension funds) which could, as institutional investors, take an active part on the domestic financial market, none of them is in the position to ensure the expansion of new types of financial services.

Policy Objectives	3. FORMATION OF THE HITHERTO NON-EXISTENT FINANCIAL INSTITUTIONS AND THE PROVISION OF NEW FINANCIAL SERVICES
Activities Planned And Performed To Date	<p>Investment Funds</p> <p>Due to the non-existence of laws and regulations, as well as an insufficient development level of the financial market, the domestic financial system is currently functioning without the presence of investment funds.</p> <p>Insurance Companies</p> <p>On the Serbian market there are 42 insurance companies of which 23 have the operating licence for more than one form of insurance, while 19 have the operating licence for one form of insurance. The high illiquidity of the insured (caused by the poor performance of the economy) influenced the low amount of available financial resources of insurance companies, as well as an unfavourable trend in the participation of specified forms of insurance in the portfolio (automobile liability</p>



<p>Policy Objectives</p>	<p>3. FORMATION OF THE HITHERTO NON-EXISTENT FINANCIAL INSTITUTIONS AND THE PROVISION OF NEW FINANCIAL SERVICES</p>
	<p>insurance is dominant, while the share of property insurance is decreasing. This especially refers to personal insurance which is crucial for the presence of insurance companies on the financial market).</p> <p>Pension Funds</p> <p>Due to insufficient funds for the settlement of current liabilities, pension funds do not appear on the domestic market as institutional investors. The financing of pensions is still based on the so-called first pillar, i.e. pensions are financed on a pay-as-you-go basis, and it is uncertain when other two methods of financing the obligations of pensions funds will be developed (individual capitalized savings and voluntary payments). So far, the new Law on Old-Age Pension and Disability Insurance has been adopted. The new provisions include the lowering of the contribution rate, extension of the pensionable age and change of the method of calculating pensions.</p>
<p>Recommendations / Comments</p>	<p>Investment Funds</p> <p>The adoption of the Law on Investment Funds, whose draft has been prepared, will create legal conditions for the presence of these institutions on the domestic financial market. However, it is much more important to spur the development of the financial market, especially the capital market, bearing in mind that the formation of investment funds is possible only after the development of secondary trading in high-quality securities in which open-end and closed-end investment funds will invest.</p> <p>After the adoption of the necessary regulations which will enable the presence of investment funds on the domestic financial market, it will be necessary to set up a special supervisory body which will monitor the work of investment funds and prevent any manipulation in their transactions, in addition to regulating the supervisory, preventive and penal functions of this institution by law.</p> <p>It is necessary to insist on the establishment of investment funds whose founders will be banks and other legal entities, while the government's participation in their management should be reduced to a minimum.</p> <p>It is also necessary to carry on a broad-based campaign for educating and informing the general public about the possibilities and advantages of investing in investment funds.</p> <p>The Central Credit Register and Credit Rating of Legal Entities (set up within the NBS) provide a sound basis for the initial monitoring of the work of legal entities whose short-dated and long-dated securities are interesting to investment funds. This information base should be developed. The analysis of business operations of domestic enterprises will be especially facilitated by the provision that enterprise must apply international accounting standards as of the beginning of 2004.</p> <p>Insurance Companies</p> <p>Currently underway is the adoption of the new Insurance Law, which will regulate</p>



Policy Objectives	3. FORMATION OF THE HITHERTO NON-EXISTENT FINANCIAL INSTITUTIONS AND THE PROVISION OF NEW FINANCIAL SERVICES
	<p>the situation on the domestic insurance market and create a basis for the beginning of the privatization process in the insurance sector, while at the same time enabling the presence of foreign insurance companies. The Law anticipates an increase in the initial capital required for the formation of insurance companies, thus stimulating the consolidation of domestic insurance companies and competition, as well as upgrading organizational, technical and personnel potentials.</p> <p>For the purpose of harmonization with the EU rules, the new legal solution provides more clearly defined forms of investment for the available resources of domestic insurance companies in comparison with the previous regulations.</p> <p>The new laws and regulations stipulate that, due to its experience in banking supervision, personnel, possibility of a fast implementation of laws, as well as the fact that a large number of banks also carries on insurance business, the National Bank of Serbia should assume the responsibility for supervision over the work of insurance companies so as to curb unfair competition.</p> <p>Pension Funds</p> <p>It is necessary to adopt the laws and regulations that will enable the application of the system of voluntary old-age pension insurance. This would enable the application of such a system by successful firms and when the system proves to be good, it can be expected that physical persons will also shift to it. For the development of the system of old-age pension insurance by means of capitalized savings, it is necessary to lay the foundation for regulating the payment of pensions on the basis of individual and capitalized savings by law. However, the final precondition for a successful implementation of this system of old-age pension insurance is the development of the financial market on which such savings can be successfully capitalized.</p> <p>To provide for an efficient and sustainable pension system, it is necessary to create institutional preconditions, primarily the Register of the Insured, as well as an independent body, which will be authorized to supervise the operation of pension funds.</p>
Responsible Institution	Ministry of Finance and Economy, Ministry for Social Affairs and the Government of the Republic of Serbia
Time Frame	<p>The Law on Investment Funds and the supervisory body authorized to supervise the operation of these institutions should be adopted/set up in mid-2004.</p> <p>The adoption of the new Insurance Law is planned by the end of May 2004.</p> <p>The Law on Voluntary Old-Age Pension Insurance should be adopted by the end of 2004.</p> <p>An educational campaign for the promotion of the possibilities and advantages of investing in institutional investors should be carried on continuously.</p>

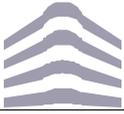
The essence of a sound and efficient financial system lies in confidence. Confidence is of utmost significance for the proper functioning of the financial system. To prevent the impairment



of that confidence, the EU has, inter alia, adopted Directive 91/308/EEC on the prevention of the use of the financial system for the purpose of money laundering. Thus, all countries which adopt the provisions of this Directive will have to meet the standards against money laundering as soon as possible, thus avoiding the use of their financial sector for the purpose of laundering the money stemming from criminal activities and, in particular, from drug trafficking. The extent to which this area is regarded as significant is also pointed out by the fact that Directive 91/308/EEC is called «horizontal», whereby one wishes to emphasize that its provisions refer to the activities of credit institutions, financial institutions, as well as the activities of institutional investors or, in a word, to all participants in the financial system.

To observe the provisions of this Directive in Serbia, it is necessary to intensify the activities against money laundering.

Policy Objectives	4. INTENSIFICATION OF THE ACTIVITIES AGAINST MONEY LAUNDERING
Activities Planned And Performed To Date	<p>The Federal Money Laundering Law was adopted at the end of 2001 (Official Gazette, No. 53/01) and came into force on 1 July 2002. To implement this Law, the Federal Commission for the Prevention of Money Laundering was set up. This institution is authorized to collect, process, analyze and keep the data obtained from those specified by Law; to provide information to the competent government bodies (judicial, inspection and police), as well as to undertake other measures against money laundering. After the adoption of the Constitutional Charter of the State Union of Serbia and Montenegro, the Commission became the institution of the Republic of Serbia.</p>
Recommendations / Comments	<p>The Money Laundering Law has been in large measure harmonized with Directive EU 2001/97/EC. The identification of money laundering activities, institutions authorized to take measures against money laundering, as well as the procedure relating to the prevention of these illegal activities has been fully harmonized with European practice. There are differences, however, in the quantitative limits for financial transactions which require the undertaking of measures against money laundering. National legislation set lower limits for the value of financial transactions which – in order to dispel suspicions that it is the question of money laundering – require the submission of the prescribed documentation for inspection. However, such a solution is regarded as justified, bearing in mind the frequent practice of channelling illegally earned money into legal financial flows. After increasing the efficiency of the competent bodies in the prevention of money laundering, it can be expected that national legislation will also be harmonized with the relevant EU standards.</p> <p>However, the adoption of the Law itself does not guarantee its adequate implementation. Although the financial services have been trained how to implement the Law, a special problem is posed by insufficient readiness of the police authorities and judiciary to take actions towards efficient control and sanctioning of money laundering.</p>



Policy Objectives	4. INTENSIFICATION OF THE ACTIVITIES AGAINST MONEY LAUNDERING
Responsible Institution	Commission for the Prevention of Money Laundering, Ministry of Internal Affairs, inspection services and judiciary.
Time Frame	The intensification of the activities of the competent bodies in the fight against money laundering, as well as the training of their personnel should be continuous.

2.6. Public Procurement

In EU member countries, the value of public procurement is estimated at about 10–12% of GDP, i.e. about 25–30% of total public expenditure. An efficient public procurement system enables the economical and efficient use of public resources, monies, as well as the promotion of competitiveness and equal treatment of bidders in public procurement procedures and adequate legal protection. For these reasons, the public procurement sector is regulated by numerous laws at the EU level, in addition to being of great significance for the Stabilization and Association Process.

The basic aims of the European Union's Acquis concerning public procurement include as follows:

- Provision of competition as a precondition for the award of public procurement contracts without discrimination;
- Rational use of public resources by selecting the best bid and
- Equal access of all bidders to the EU internal market and markets of third countries.

Before the adoption of EU public procurement legislation, only 2% of public procurement contracts within the EU were awarded to firms outside the client's home country. The absence of competition in this area posed a serious obstacle to the creation of the EU single market. In addition to the fact that the use of public resources was not sufficiently efficient, the absence of competition in major industries slowed down the development of some European firms and weakened their competitive position at the global level.

One of the major aims of the Community in the field of public procurement was to enable all firms to bid for public procurement contracts under equal terms. To this end, the legal framework was established for the award of public supply, public service and public works contracts when the clients are bodies of central or local government, as well as entities operating in the water, energy, transport and telecommunications services sectors. The Treaty establishing the European Union does not directly regulate public procurement, but lays down the basic principles of free movement of goods and services, which also refer to public procurement systems.



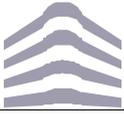
Public procurement procedures conducted in different countries have been harmonized by adopting the EU Directives regulating this sector in detail. The Directives were needed to ensure that public contracts within the EU become accessible to firms from member countries under equal terms and that public procurement procedures become more transparent so as to be harmonized with the principles laid down in the Treaty. The harmonization of national public procurement rules by means of directives covered the appropriate announcement and transparency; the priority order of different contract-awarding procedures, common rules on technical specifications, as well as the criteria for the selection of bidders and award of contracts. The Directives also regulate the procedures relating to the compensation of firms for damages, as well as legal remedies should the EU public procurement rules be violated. harmonizatio The application of these EU rules is supervised by the Commission and the Court of Justice whereby, in cooperation with national courts, a comprehensive body of case law has been created, thus supplementing the legal framework of these Directives.

The *Acquis Communautaire* concerning public procurement can be divided into three major parts:

- Public procurement when the clients are bodies of central, regional or local government;
- Public procurement when the clients are entities operating in the water, energy, transport and telecommunications services sectors, and
- Legal remedies or procedures for the protection of bidders' rights.

Public procurement when the clients are bodies of central, regional or local government, as well as entities under their supervision are regulated by Directives 93/36/EEC, 93/37/EEC, 92/50/EEC and 97/52/EEC. For the most part, the provisions of these Directives have been incorporated into member countries' legislations. The Directives stipulate the procedures for the award of public procurement contracts, including the rules on the invitation to bid, time-limits for the submission of bids, as well as the use of the common European standards in setting technical requirements. They also regulate the procedures for the selection of the best bidder, which enable the greatest possible competition, as well as the laying down of the criteria for the selection of the best bidder and award of the contract. As for the selection of the best bidder, the criteria must include the bidder's technical potentials and reputation, while the contract-awarding criteria are the lowest price or the economically best bid (taking into account the price, time of delivery, etc.).

Public procurement when the clients are entities operating in the water, energy, transport and telecommunications services sector is regulated specifically by Directives 93/38/EEC and 98/4/EEC (amendments to 93/38/EEC). In addition to public bodies and public enterprises operating in the above mentioned sectors, these Directives stipulate private entities which have special rights, granted by member countries, to operate in the mentioned sectors. In view of the fact that some of these entities are liable to public law and others to private law, the relevant EU rules are more flexible than those relating to the clients at the level of central, regional



or local government (11). The Directives regulate the public procurement of goods, services and construction work within the scope of the following activities:

- Provision or operation of the systems for the production, transport or distribution of drinking water, electric power, gas or heating;
- Extraction of crude oil and gas, or coal mining, or the provision of seaports or inner ports, airports or other cargo terminal facilities for carriers;
- Operation of railway, tramway or bus transportation systems, and
- Operation of public telecommunications networks, or the provision of public telecommunications services.

The third integral part of the Community's Acquis relating to public procurement (Directives 89/665/EEC, 92/50/EEC and 92/13/EEC) is devoted to legal remedies for the protection of bidders' rights in the case of violation of EU legislation. The content of these Directives is oriented towards an effective and fast procedure in the case of a complaint, especially when the contract-awarding procedure is conducted rapidly, as well as towards the revocation of unlawful decisions and the compensation of firms suffering the damage. These legal remedies also anticipate the suspension of the contract-awarding procedure, revocation of unlawful decisions and discriminatory technical, economic and financial specifications relating to public procurement, as well as the compensation of the firms suffering the damage. Directive 92/13/EEC regulates the issue of efficient auditing procedures relating to the award of public contracts in the water, energy, and transport and telecommunications services sectors.

The harmonization of legislations and efficient implementation of public procurement laws are important preconditions for the conclusion of the Stabilization and Association Agreement (SAA) with the EU. All candidate countries undergoing the process of stabilization and association with the EU have already harmonized their laws with the relevant EU Directives. A prerequisite for the successful harmonization and implementation of public procurement legislation is the existence of the legal framework enabling the free movement of goods and services, competition among economic entities and supervision of public assistance.

The concrete measures for harmonization of national legislations anticipate the existence of the bodies in charge of public procurement. It is necessary to identify the entities that approve awards and classify them according to the volume of procurement into central government bodies, local government bodies and entities in charge of public procurement in the water, energy, transport and telecommunications services sectors. It is also necessary to set up the institution authorized to manage the public procurement system. For announcing bids for a public procurement contract, it is necessary to use printed media with the nation-wide circulation. It is also anticipated to set up the body in charge of the protection of bidder's rights in the case of complaints, regardless of whether a judiciary or quasi-judiciary body is in question.



In the previous period, public procurement in Serbia accounted for about 9.5% of GDP (gross domestic product). The Public Procurement Law in Serbia, adopted in July 2002, regulated the method and procedure relating to the public procurement of goods and services, as well as the execution of construction work for the first time. This Law was prepared by using the model applied by the countries whose negotiations with the EU were well underway, and it has been harmonized for the most part with the key EU Directives. In addition, it regulates public procurement procedures in detail, contains modern provisions relating to open and restrictive competitions, time-limits, de minimis public procurement and the selection of bidders. In order to fight against corruption, the specific anti-corruption article has also been adopted. In accordance with this article, the client is obliged to decline a bid if he has enough evidence as to the irregularity of the procedure.

As stipulated by this Law, the public procurement system must ensure economy, efficiency and transparency in the use of public resources; promote competitiveness and equal treatment of bidders in public procedures and provide appropriate legal protection. Within the provision of this Law, the Public Procurement Administration has been set up as the body authorized to perform specialized activities and exercise supervision over public procurement procedures. To protect the rights of bidders, the Commission for the Protection of Bidders' Rights has been established within the Public Procurement Administration. It is authorized to stop the public procurement procedure, or proclaim it invalid, partially invalid or valid.

The current Public Procurement Law in Serbia equalizes the status of foreign and domestic bidders in public procurement procedures. At the beginning, in most countries in transition, domestic bidders enjoyed a specified degree of protection. Over time, however, this protection was declining and was finally terminated, thus equalizing the status of domestic and foreign bidders in full. The current proposal for amending the Public Procurement Law included the solution according to which domestic bidders are provided a contract if they are up to 20% more favourable in terms of the price or the point rating relative to foreign firms. Such a solution could be applied over a specified period of time, after which the status of domestic and foreign firms should be equalized. In Croatia and Macedonia, under the Stabilization and Association Agreement (SAA), the time-limits are three and five years respectively. Within this period, they should equalize the status of domestic and foreign bidders. In return, Croatian and Macedonian companies were enabled to have immediate access to all public procurement contracts with the Community, under the same terms as those applicable to firms from the EU. While making the final decision, one should bear in mind that, apart from good sides of this solution, there are also bad sides which reflected primarily in an increase in public expenditure.

Policy Objectives	HARMONIZATION OF THE PUBLIC PROCUREMENT PROCEDURE WITH THE EU DIRECTIVES
Activities	The Public Procurement Law, adopted in July 2002, has been fully harmonized



Policy Objectives	HARMONIZATION OF THE PUBLIC PROCUREMENT PROCEDURE WITH THE EU DIRECTIVES
Performed To Date	with the EU requirements. This Law created conditions for the efficient use of public resources, as well as the promotion of competitiveness and equal treatment of bidders in public procurement procedures. The major deficiency of the current public procurement system in Serbia is the non–existence of an efficient system for the protection of bidders' rights. The EU Directives on public procurement anticipate the formation of a body which will efficiently, and within the shortest possible time, decide on all requests for the protection of rights in the procedures for the award of public procurement contracts. The current Commission for the Protection of Bidders' Rights, which was set up in May 2003, has no professional and technical potentials for the efficient performance of its function.
Recommendations / Comments	<p>In the public procurement procedure it is necessary to provide maximum legal protection to bidders. By amending the Public Procurement Law, it is necessary to define the status of members of the Commission for the Protection of Rights. In that sense, the Chairman of the Commission should – as regards his rights and responsibilities – acquire the status of the director of a special administrative agency and four members of the Commission the status of his assistants. In this way, the Commission for the Protection of Bidders' Rights would use the logistics and infrastructure of the Public Procurement Administration, thus solving the problem of non–existence of professional services and technical preconditions for its successful work. In the amendments to this Law it should also be stipulated that the Chairman and members of the Commission cannot perform any other function, thus ensuring their independence and impartiality.</p> <p>In accordance with Directives 89/665/EEC, 92/50/EEC and 92/13/EEC on legal remedies, which insist on an accelerated procedure for deciding on requests for the protection of bidders' rights, while the time–limits for decision–making should be shortened: at first instance (when the client makes a decision) from 20 days at present to 10 days, and at second instance (when the Commission makes a decision) to 15 days, or to 25 days in special cases. In addition to the provision of legal security of participants in the public procurement procedure, this will ensure promptness in deciding on requests for the protection of rights.</p> <p>For the efficient protection of bidders' rights, in accordance with the mentioned EU Directives on legal remedies, it is necessary to ensure active legitimation (i.e. the possibility of participating in the procedure of protection of rights) for every person that has, or might have an interest in being awarded the public procurement contract. The current legal provisions provide for the participation in the procedure of protection of rights only for persons that have participated in the public procurement procedure as bidders.</p> <p>Apart from the protection of bidders' rights, in this procedure it is also necessary to protect the public interest should it be affected by harmful actions of the bidder. In this regard, the right to request the protection of the public interest should be conferred to the Public Procurement Administration and the Republican Attorney General.</p> <p>In order to lessen the possibilities for the abuse of public funds still further, it is</p>



Policy Objectives	HARMONIZATION OF THE PUBLIC PROCUREMENT PROCEDURE WITH THE EU DIRECTIVES
	<p>necessary to authorize the Public Procurement Administration to request from each orderer to submit the report on each awarded contract, as well as to inspect as to whether the procedures specified by law have been observed. Supervision over public procurement procedures would be additionally strengthened by the external audit of public procurement contracts by the Supreme Auditing Institution. Until such an institution is set up, the ministries should hire independent auditing firms to audit these contracts on an annual basis.</p> <p>The current legal provisions provide for the bidder's obligation to submit detailed documentation on the fulfilment of the public procurement requirements for each public procurement procedure. By amending the Public Procurement Law, it will be necessary to stipulate that the once prepared documentation should be valid for a period of six months, whereby the overall procedure would be simplified, accelerated and cheaper.</p> <p>In the coming period it will be necessary to adopt all necessary sublegal enactments on public procurement, such as: the list of orderers, standard statistical forms, standard announcement forms, etc. It is especially important to specify the standard documents for the public procurement of goods, services and construction work for all orderers.</p>
Competent Institution	Ministry of Finance of the Republic of Serbia
Recommended Time Frame	By mid-2004, it would be necessary to adopt the amendments to the Public Procurement Law, as well as the accompanying laws and regulations.



CONCLUSIONS

Integration into the European Union represents the basic long-term strategy of Serbia's foreign policy and the only possible path of its further development, bearing in mind the long-term benefits of the integration process and the feeling of the greater part of the population.⁴² In the process of accession to the EU, Serbia is lagging behind other countries of South Eastern Europe. The reasons should be sought in its political problems and delays in the implementation of economic reforms, as well as in insufficient knowledge about the EU rules, principles and regulations. One of the aims of this Study was just to point out what should be done in the selected area so as to harmonize the domestic system with that of the European Union.

The accession of Serbia and Montenegro to the European Union depends on the adjustment of the basic state principles to the political, legal and economic requirements of the EU member countries and on the political will of its citizens. The formulation of the policy, adoption of laws, establishment of institutions and creation of a functional administration require sustained efforts.

The intention of the members of the Economics Institute's team, who were involved in the preparation of this study, was to assist in formulating and implementing an analytical and planned approach to reforms by identifying the measures in the key areas of economic life, which require harmonization with the EU norms, as well as to define the activities that should be carried out with a view to maximizing the benefits and minimizing the costs of the integration process. To this end, the Study was divided into two parts: theoretical and practical. In its theoretical part, the experiences of other economies in transition with the process of accession to the EU is analyzed. The starting point was the experience of these countries, which is combined, in the practical part, with Serbia's specifics, that is, the possibilities for its implementation. The practical part, in which the expected effects of concrete theoretical measures and potential risks are analyzed, has three components: the first component includes a comprehensive analysis of everything that was done with respect to the EU requirements in the defined areas; the second provides the recommendations and measures of a systemic/institutional reform relating to the pace and method of adjusting the domestic economy to the EU requirements; and the third component refers to SWOT analysis that points to potential threats, on one side, and contributes towards resolving the dilemma concerning the impact of accession to the EU on well-being, on the other side.

The unambiguous conclusion of the Study is that there are numerous discrepancies vis-à-vis the EU regulations in the observed areas, so that it is necessary to intensify the efforts towards the harmonization of the domestic system with that of the European Union. The other

⁴² The latest public surveys in Serbia show that most citizens, nearly 70%, regard Europe as something to which Serbia should aspire.



important conclusion, which was derived from SWOT analysis, is that the process of accession to the EU entails numerous benefits, as well as potential threats, due to which the process of harmonization should be based on a gradualist approach, thus minimizing the potential costs of accession to the EU.

In our view, the structure of the project enabled the achievement of the basic aim of the Study **»The Measures of the First Phase of Accession of Serbia and Montenegro to the EU Within the Stabilization and Association Process«**, which is reflected in the provision of recommendations and the preparation of the plan of activities in conformity with the measures of the first phase of harmonization, which are recommended for all accession candidate countries by the EU. We also hold that this Study will be a useful guide for economic policy-makers in Serbia and Montenegro to all necessary reform-related activities and measures that should be implemented in the selected areas, thus enabling the unhindered process of harmonization with the EU standards and the country's fastest possible integration into the community of the European countries.



REFERENCES:

1. "The Tessaaloniki agenda for the Western Balkans: Moving towards European Integration" (2003), Council Conclusions, http://europa.eu.int/comm/external_relations/see/gacthess.htm
2. Batory, A. (2003), "The Legal Implications of EU Enlargement: Hungary, Poland and the Czech Republic", European Programme Working Paper May 2003, The Royal Institute of International Affairs.
3. Berry C. R., 1997, "The Global Economy in Transition", Prentice Hall
4. Bevan, A. and S. Estrin (2000), "The Determinants of Foreign Direct Investment in Transition Economies", [William Davidson Institute Working Papers Series](#) No. 342.
5. Blejer I.M. and Skreb M., editors (1997), "Macroeconomic Stabilization in Transition Economies", Cambridge University Press
6. Buch C. and others, 1995, "Overcoming Obstacles to Successful Reforms in Economies in Transition", Institut fuer Weltwirtschaft, Kiel
7. Commission of the European Communities, 2004, "The Stabilization and Association process for South East Europe – Third Annual Report", www.europa.eu.int/comm
8. De Melo M. and others, 1996, "From Plan to Market", Policy Research Working Paper 1564, World Bank, Washington DC
9. Dimitrijevic, B., 2002, "Comparative Analysis of Costs and Benefits of European Union Accession in the selected countries", SCEPP
10. Djukic, Dj., Marovic N. and Djukic M., 2003., "Optimal Deposit–Guarantee Scheme in the Case Accession Process to EU – A Case Study of Serbia and Montenegro", ASECU Conference, 2003, Economic Cooperation in South Eastern Europe, Belgrade
11. Dominese G., "An Italian Point of view – Transition beyond Enlargement: rethinking next European Governance", CEEUN, University of Udine
12. Drabek Z., 1996, "The Stability of Trade Policy in the Countries in Transition and their Integration into the Multilateral Trading System", The World Economy, Blackwell Publishers, Oxford
13. Dutz, M.A and M. Vagliasindi (2001), "Competition Policy Implementation in Transition Economies: an Empirical Assessment", EBRD Working Paper No. 47.
14. EBRD, 1997, "Transition Report"
15. EBRD, 1999, "Transition Report"
16. EBRD, 2000, "Transition Report"
17. EBRD, 2003, "Transition Report"
18. EBRD, 2004, "Spotlight on south-eastern Europe", London
19. EBRD, 2004, "Transition Report"
20. Economics Institute, 2003, "Expected Measures of Harmonization in the Process of Negotiation of Stabilization and Association Agreement with EU", Belgrade
21. Economist Magazine, "Harmonisation", 2004, Belgrade
22. European Commission, 2001, "European Economy – Enlargement papers –The economic impact of enlargement"
23. European Commission, 2003, "Enlargement Strategy and 2003 Report on the Candidate Countries",
24. European Commission, www.europa.eu.int/comm
25. Fabris N., Galic J., 2003, "Improving a Business Environment in the Process of Transition of Serbia and Montenegro", Economic Cooperation in South Eastern Europe, Belgrade
26. Filipovic S., Petrakovic D., Nedeljkovic M., 2003, "Main Characteristics and Tendencies of Banking system Development in South Eastern Europe Transition Countries", Economic Cooperation in South Eastern Europe, Belgrade



27. Hanousek, J. and G. Roland (2002), "Banking Passivity and Regulatory Failure in Emerging Markets: Theory and Evidence from the Czech Republic", Centre for Economic Policy Research Discussion Paper, No. 3122.
28. Harvard Institute for International Development, Benchmarking Competitiveness in Transition Economies
29. IMF Institute, 2003, "Competitiveness in the Baltics in the Run-Up to EU Accession"
30. IMF, 2002, "The Baltics: Medium-Term Fiscal Issues Related to EU and NATO Accession"
31. Institute of Economic Sciences, "White Paper 2001, Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the European Union", Belgrade
32. Istvan A. and Bonin John P., 1999, "The 'Big Bang' Versus 'Slow but Steady': A Comparison of the Hungarian and Polish Transformations", CEPR Discussion Paper No. 626, CEPR, London
33. Jacobsen, C.B. (2001), "Adaptation of the Legal Systems of Candidate Countries – The Case of the Baltic States," DUPI Working Paper No. 2001/8, Copenhagen: Danish Institute of International Affairs.
34. Lavigne M., 1995, "The Economics of Transition - From Socialist Economy to Market Economy", St.Martin's Press, New York
35. M. Lavigne, 1995, "The Economics of Transition"
36. Ministry of Social Affairs Republic of Serbia, 2003, "Poverty Reduction Strategy Paper For Serbia", Belgrade
37. NBS, 2003, Annual report, Belgrade
38. Official Gazette, 24/01, Law on Personal Income Tax
39. PLAC, 2003, "Development of Competition Law and Policy in Serbia and Montenegro in the Context of the EU Stabilisation and Association Process" , Belgrade
40. PLAC, 2003, "The Development of Financial Services in the State Union of Serbia and Montenegro", Belgrade
41. PLAC, 2003, "The Development of Public Procurement in Serbia and Montenegro", Belgrade
42. PLAC, 2003, "Advisory report on the development of the transport sector in Serbia and Montenegro in the context of the EU stabilization and association process", Belgrade
43. Ramunas Vilpisauskas and Guoda Steponaviciene, 1999., "Winners and Losers of EU Integration in Central and Eastern Europe: The Case of the Baltic States - Economic part"
44. Royal Institute of International Affairs »The Legal Implications of EU Enlargement«
45. Serbia and Montenegro European Integration Office, 2003, "Serbia and Montenegro and the European Union", Belgrade
46. Serbian Economic Association, 2003, "Evropska integracija Srbije" ("European Integration of Serbia"), Kopaonik Business Forum
47. Stamenkovic S., "A contribution to the Study "A Contribution to the Preparation of Serbia's Strategy for the FRY Accession to the EU", Ministry for International Economic Relations, Belgrade
48. World bank, 1996, "World Development Report: From Plan to Market"
49. Yugoslav Economic Association, 2001, "Jugoslovenska privreda i Evropska Unija – izazovi i mogućnosti" ("The Yugoslav Economy and the European Union – Challenges and Possibilities"), Belgrade