

Corruption and doing business in Serbia

Small and Medium-Sized Enterprises (SMEs) have been described as ‘the backbone’ of the economy of the Western Balkans.¹ Indeed, with SMEs making up 99% of Serbian companies, employing 53% of the working population, this is certainly true for Serbia. A significant amount of companies is still state-owned, but privatisation is anticipated for the majority of these companies in the years to come. Both private and state-owned companies experience corruption, though of different kinds.



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The following brief will shortly present available data on corruption in the process of doing business in Serbia. It will then give an outline of the types of corruption businesses face, and of some problems contributing to the problem; finally, it will present some responses taken so far and needs identified.

Policy framework

Private sector development has been one of Serbia’s strategic objectives set out, inter alia, in the 2004-2010 Poverty Reduction Strategy Paper, and in the 2005 National Strategy for EU accession. A specific Strategy for the Development of SMEs spans the period from 2003 to 2008. An Agency for the Development of Small and Medium-Sized Companies was already created in 2001. In a recent statement, the new Deputy Prime Minister of Serbia announced his government’s objective of Serbia becoming one of the most competitive economies in Europe, and the country joining the European Union by 2014.² The challenges are significant: businesses operate in spite of bureaucracies with extremely low capacities, most of which have yet to develop a service culture that would understand its role as a facilitator for business growth; there is a lack of adequate infrastructure, and business skills are not yet sufficiently developed. Serbia has applied, in 2004, to join the World Trade Organisation, and is expected to ratify the Central European Free Trade Agreement (CEFTA) in September 2007.

With regard to state-owned enterprises, privatisation³ is being pursued, although less vigorously than the key financial institutions (World Bank, IMF, EBRD) would argue for. The process is, in part, being troubled by politicians’ realisation of the potentially high political price, and the impact on social peace that the privatisation of ‘strategic’ enterprises has. But shying away from unpopular decisions has also helped

shifting the attention from the fact that massive amounts of subsidies from the state-budget are going into sustaining these enterprises; with directors and managers not being accountable to anybody but the party through which they were appointed, and possibly substantial amounts of money being siphoned off into private pockets. The resistance, to date, to establish a strong independent external audit function can partly be attributed to the potential of revealing cash flows to these companies.

Problems and Responses

Survey data

The 2005 EBRD-World Bank Business and Enterprise Environment Survey (hereafter: BEEPS), the most representative survey capturing both state-owned and private businesses in transition economies, paints a rather sober picture on obstacles to doing business in Serbia.⁴ Compared to 2002, the number of companies which reported that corruption was a problem for doing business had risen to 50% (compared to 30% in 2002). Corruption as a perceived problem for doing business was worse in Serbia than in the rest of the region, and considerably worse than in other transition countries. At the same time, BEEPS found that bribes as the share of annual sales – the so called ‘bribe tax’ – was lower than in 2002, and lower than in the rest of region and other transition countries, suggesting that bribing had become more frequent, while the average size of the bribe had fallen. This has been interpreted as an indication that administrative corruption has been on the rise.

Judiciary

In a survey carried out in 2005 by the Serbian Agency for SMEs, 27% of respondents named the judiciary as the biggest problem when doing business. The BEEPS found this figure to be significantly higher:⁵ 52% of respondents in 2005, compared to 35% in 2002, confirmed that the judiciary was a problem. These findings are complemented by figures on the public’s overall low trust in the judiciary (around 38% of respondents in a survey by Transparency International stated that corruption in the judiciary was widespread),⁶ and by qualitative analyses on doing business in Serbia.⁷ A number of reform strategies have been undertaken to, *inter alia*, ensure independence, and improve efficiency, account-

ability, and transparency of the judiciary. Among these are the 2006 Judicial Reform Strategy and Action Plan. The implementation of the Strategy is still at the early stages. Given that the reform of the judiciary is one of the priorities when seeking EU membership, the European Commission will monitor progress closely. This will hopefully provide a strong incentive for decisive implementation.

Legal uncertainty and lack of implementation of new legislation

As Serbia and countries of the region continue on their reform path, the legal and regulatory environment, including for businesses, changes rapidly. Poorly drafted and hastily adopted legislation often triggers the need for swift adjustments and improvements to the new legislation. In particular, poorly organised and represented SMEs struggle to keep up with changing laws. The 2005 BEEPS found that regulatory uncertainty was a problem for 80% of businesses in 2005. Receiving information and training on new laws and regulations is also a problem for bureaucrats, such as e.g. tax inspectors. This is particularly problematic at the local level, where capacity is very low. As a result, new legislation is insufficiently implemented, a problem pointed out by many.

Poorly drafted legislation also provides some scope for extortion of businesses. The provisions of the environmental law, for example, leave it up to local authorities to set the level of taxation on environmental impact of local businesses. The law neither stipulates the frequency with which rates can be increased, nor by what percentage. There is evidence that this has been abused by local governments. By threatening businesses with a disproportionate increase in taxes, local authorities were able to extract substantial informal payments from businesses wishing to stop them from evoking their legally held discretionary powers.

Taxation and tax collection

The area of taxation has, in recent years, undergone significant changes in order to comply with EU standards, and substantial technical assistance has been provided by the EU. For example, a VAT system was introduced in 2005, replacing the sales tax that had been levied until then. According to the Serbian Ministry of Finance, tax revenues have risen by around 30% since 2004.⁸ However, experts concede that some of the problems identified by entrepreneurs in the 2005 BEEPS survey remain. Almost 75% of businesses reported having a problem with high tax rates (i.e. the system of taxation is being perceived as unjust), and 60% to having a problem with the tax administration. Over 20% of respondents reported having to pay bribes frequently to tax inspectors. The SME Agency laments tax inspectors' lack of knowledge about new provisions, particularly at the local level. Tax morale is low, and tax fraud and evasion are common. In 2006, losses to the state budget from tax evasion were estimated at around €1 billion, almost half the size of foreign direct investment for that year.⁹ Sanctions for relatively minor offences are disproportionate. For example, if a business is unable to provide certain certificates on the spot, this can be punished with immediate closure of the business in question, and re-opening it can take several weeks. When faced with the prospect of closure and loss of business, the alternative of bribing the tax inspector – who otherwise receives a very low salary – appears to be a tempting solution for both parties. For a sustainable change, work will need

to focus on systematic and continued training of staff of the tax administrations on the one hand, and entrepreneurs and the public on the other hand on the significance of tax revenues for the functioning of the state. And finally, the government must also undertake convincing steps to prove to the public that taxes are put to good use.

Customs

The customs regime, too, has undergone substantial reforms in an effort to align the system with EU standards. Progress acknowledged by e.g. the World Bank, includes the introduction of an electronic filing system for customs declarations, electronic data exchange, and targeted inspections. As a result, import time has dropped from 44 to 12 days, and export time from 32 to 11 days.¹⁰ These measures have been made possible through substantial technical assistance projects provided by the European Union's CAFAO programme, and the joint WB, US and EU project on Transport Facilitation in South-Eastern Europe (TFSE)¹¹ and others. The capacity of the customs to intercept smuggled goods has increased. Still, over 20% of 2005 BEEPS' respondents stated that bribery to customs was frequent, and all observers highlighted ongoing problems related to border customs, as well as viewing progress in the area of integrity and fighting corruption as minimal, despite a 2004 'Strategy for the Fight against Corruption in the Customs' and the technical assistance provided. The legacy of the past is likely to play a detrimental role in the introduction of an honest customs regime: the customs were an integral part of the elaborate system of smuggling during the wars of Yugoslav succession in the 1990s, and a decisive break with the past will be necessary to introduce new standards of behaviour. Furthermore, as in other areas of the public service, salaries in the customs service are dismal, which reinforces a strong incentive for corruption.

Inspections

The custom service's reputation is probably worsened even further by the fact that numerous other non-customs related services are present at the border. Importers and exporters can mistake various other inspections at the border for customs services, when they are in fact not. At the heart of the problem lies the requirement of a substantial amount of documentation (for example on compliance with phytosanitarian standards, etc.) to be submitted at the border. Obtaining these documents can be a lengthy process, making it attractive to shortcut the process by bribing an inspector at the border. Inspectors at senior level have, for example, been involved in recent scams where they have falsely declared crude oil derivatives as diluents for further use in production, and thereby avoiding excise duty and attempting to defraud the state budget by millions.¹² The 2006 Integrated Border Management Strategy specifies, *inter alia*, measures to reform the border system of inspections to comply with EU and WTO standards. However, local-level inspections are also a problematic. According to the 2005 BEEPS, many reported that they frequently had to pay bribes to occupational health and safety inspectors (23% of respondents) and to fire and building inspectors (18% of respondents). Like in other countries of the region, inspections are the responsibility of different line ministries, and a lack of coordination between the different services leads to substantial unpredictability for businesses as to what type of inspection will be made, and when.

Business licenses

There has been widely acknowledged progress on business registration. A Business Registration Law has been passed, and an Agency for Business Registers was established. Registering a business has become an administrative function (as opposed to having been previously located in the commercial courts). More importantly, setting up a business has become easier and faster. The number of certificates and documents to be provided to open a business has decreased, and so has the potential for corruption to occur at all stages of obtaining these documents. As a result, there has been a tangible increase in the growth of business registrations. Equally, the allocation of tax numbers to new businesses by the tax authorities has been cut from seven to three days, and it is currently being discussed to further streamline this process by making the Agency for Business Registers responsible for allocating this number. Since the beginning of 2007, 6 494 new companies have been registered, and a projected end of the year figure for 2007 is expected to constitute a 15% increase compared to 2006.¹³

Privatisation

Privatisation of state-owned/publicly-owned enterprises has taken place within different legal frameworks since 1989. Some 800 socially-owned enterprises and many of the around 6 000 state-owned enterprises are still to be privatised. The impressive real GDP growth in recent years has been substantially influenced by the results from the privatisation process. There have been – for the most part unproved – allegations of corruption surrounding a number of privatisation deals, in particular when they involved companies that were competitive, and therefore attractive to investors. The allegations involved deliberately undervaluing state property for the benefit of potential buyers, the leaking of information to select competitors, and the intimidation of potential bidders. A recurring concern is that the privatisation process is used to legitimise illicitly obtained money. More seriously, managers are known to strip off assets of the socially-owned companies they are in charge of, by selling parts to private buyers, despite being aware that such sales will be annulled by the Privatisation Agency. According to the Privatisation Agency, there are around 20 tip-offs on such practices every week.

Private-to-private corruption in the post-privatisation process

The post-privatisation process provides opportunities for private-to-private corruption. For example, Successful bidders can declare insolvency which results in them being unable to pay the instalments for the enterprise. The shares for the enterprise are then auctioned at the stock exchange, where they can be deliberately undervalued, against kick-backs, and the same bidder can (through proxy) purchase the company for a fraction of the price bid at the first auction.

Public Procurement

Progress has been made in the area of public procurement. A Law on Public Procurement in line with EU standards has been passed, and an independent agency, the Public Procurement Office, has been established to monitor the effective implementation of procedures. Savings have been recorded since the entering into force of the new law, and the percentage of competitive versus negotiated procurements is now broadly in line with international standards. In 2005, com-

petitive procurements were at 73% of the overall number of procurements concluded.¹⁴ More efforts are necessary to sustain and increase the capacity of the Public Procurement Office, which is currently operating with a bare minimum of staff needed to maintain the quality of procedures. More resources are necessary, and salaries must be improved in order for the Office to retain trained and qualified staff.

Underdeveloped private sector representation

While foreign investors have organised in order to present their interests in a concerted way to the government, more needs to be done to facilitate the organisation of local SMEs.¹⁵ Funded in part by the government, The Agency for SMEs aims at facilitating such efforts, but progress is relatively slow. Part of the problem lies in the negative experiences businesses have with the compulsory membership in the largely unreformed Chamber of Commerce. Services delivered by the Chamber are said to be of poor quality, which undermines the entrepreneurs' faith in the potential of business representation. Ultimately, membership in business interest groups is also often hampered by the businesses' own limited resources. Hence, a great potential for donor assistance exists, in particular at the local level.

Other International Standards and Instruments

OECD Anti-Bribery Convention

While adhering to the OECD Convention on Combating Bribery of Foreign Public Officials is not an immediate objective of Serbia, the influence of OECD member countries' companies on the quality of conducting business in Serbia has been noted by observers. For example, the Foreign Investors Council reports that companies are aware of constraints put on them by the Convention. This is a good example of Western countries leading by example, and it is hoped that this will contribute to a change in the overall standards of conducting business in Serbia.

Corporate Responsibility Standards and Codes of Conduct

The importance of corporate responsibility – including general principles such as ethical standards, accountability to shareholders and the public, and transparency – is slowly becoming recognised in Serbian business circles. There are a number of civil society initiatives, such as Smart Kolektiv's Responsible Business Initiative,¹⁶ which have specific corporate responsibility projects. 2006 also saw the creation of a Working Group specifically dedicated to the introduction of the concept of corporate responsibility to a wider Serbian business community, in compliance with UN Global Compact, where one of the ten principles is the commitment of companies to take anti-corruption measures.

Regulatory Impact Assessment (RIA)

Regulatory Impact Assessment (RIA) has been made mandatory for all new legislation in 2004. A project supporting the development of a regulatory reform strategy is underway with funding from Sida and implemented by the World Bank. The objective of the strategy is to de-clutter the regulatory burden for business, but also to increase the capacity of the government to conduct genuine, broad stakeholder consultations on the real life impact of new legislation and regulations. At the moment, the capacity, resources and skills to reach out to stakeholders is low. At the same time, due to the above mentioned lack of strong representation of

businesses, so is the private sector's capacity to participate in a meaningful way in such consultations.

Charter for Small Enterprises

Serbia, as other countries in the region, has joined a regional peer review process in the framework of the EU Charter for Small Enterprises.¹⁷ The Charter puts emphasis on the development of small enterprises as the source of new jobs and economic development. Countries commit, *inter alia*, to take measures to develop entrepreneurial skills and business representation, and to improve legislation and regulation. The regional process is guided by the OECD's Investment Compact for South-Eastern Europe,¹⁸ and regional countries have assessed it as being extremely useful.

Recommendations for Donors

Corruption occurs at the interface of public administration and private business. Donors' should support measures on both sides:

Support to minimising corruption in public administration could include:

- the strengthening of existing institutions such as the Public Procurement Office, and the Agency for the Development of Small and Medium-Sized Enterprises;
- measures to advance the reform of the tax system, and in particular, the systematic training of tax inspectors on the implementation of new legislation and regulations;
- measures to reform the system of inspectorates;
- measures to continue the reform of the customs administration, in particular integrity and anti-corruption measures;
- measures to increase the capacity at the local-government level to facilitate business development.

Support to the private sector could include:

- helping the private sector to better organise and represent their interests vis-à-vis the administration;
- initiatives to develop entrepreneurial skills and good practices/standards, including on ethical standards and corporate responsibility values.

References

1. See, for example, a statement by the OECD at www.oecd.org/document/23/0,3343,en_35424885_35425005_38312343_1_1_1_1,00.html
2. See Serbian Business News: 'Serbia's Strategic Goal to Build the Most Competitive Economy in Europe', 6 August 2007, at www.economy.co.yu/eng/index.php?action=news&subact=full&id=443

3. Privatisation is governed by a number of laws, which are available at the website of the Serbian Privatisation Agency (in charge of the technical aspects of privatisation) at www.priv.yu/pravni_okvir/uvod.php?jezik=english
4. The BEEPS captured businesses in Serbia AND Montenegro. However, the amount of Montenegrin businesses was very small (20 companies out of 250 in the 2002 survey, and 18 companies out of 300 in the 2005 survey). The data quoted throughout this brief is available at <http://siteresources.worldbank.org/INTECAREGTOPANTCOR/Resources/BAAGREV20060208SAM.pdf>.
5. This might be due to the fact that the BEEPS captured a different spectrum of companies.
6. See, in Serbian, www.transparentnost.org.yu/aktivnosti/poverenje/materijal/6.%20Prezentacija%20glavnih%20nazaza%20istrazivanja%20TS.ppt
7. See, for example, the 2006 report of the Belgrade-based Jefferson Institute 'Competitiveness of the Serbian Economy' at www.jeffersoninst.org/Home.asp, and the White Book of the Foreign Investors' Council (FIC) at <http://www.fic.org.yu/>
8. See, in Serbian, www.b92.net/biz/vesti/aktuelno.php?id=142,5 January 2007
9. Ibid.
10. See http://siteresources.worldbank.org/INTCROATIA/Resources//301144-1157631699840/DB07_EE_press_release_eng.pdf, p.2
11. See the project's website at <http://www.ttfse.org/>
12. See, in Serbian, www.b92.net/info/vesti/index.php?yyyy=2007&mm=05&dd=29&nav_category=120&nav_id=24882
13. See Serbian Business News: '6,494 New Firms Register', 3 August 2007, at <http://www.economy.co.yu/eng/index.php?action=news&subact=full&id=441>
14. See 2005 report of the Public Procurement Office, in Serbian at www.ujn.sr.gov.yu/Attachments/izvestaj2005.pdf
15. There is a compulsory requirement for all businesses to be member of the (largely unreformed) Serbian Chamber of Commerce. However, there is significant dissatisfaction of the way in which the Chamber provides services to its constituency, which undermines businesses' belief in the usefulness of representing its own interests.
16. See www.smartkolektiv.org
17. The charter can be found at http://ec.europa.eu/enterprise/enterprise_policy/charter/index_en.htm
18. See the Investment Compact's website at www.investmentcompact.org/pages/0,2987,en_35424885_35425005_1_1_1_1,00.html