



EDIF REFORM PRIORITISATION SERBIA

Belgrade, October 1st 2012



THE ENTERPRISE DEVELOPMENT AND INNOVATION FACILITY

The Western Balkans Enterprise Development and Innovation Facility (WB EDIF) is a joint initiative of the European Commission, the European Investment Bank (EIB) and the European Investment Fund (EIF) and the European Bank for Reconstruction and Development (EBRD) set up through the Western Balkans Investment Framework. The Organisation for Economic Cooperation and Development (OECD) provides analytical policy support to this initiative. The facility is expected to raise over 140 million Euros of capital to benefit access to finance for SMEs through equity funds for innovative and high growth SMEs (IHGSMEs) as well as credit guarantees for SME credit. Its objective is to enhance the provision of finance to SMEs in the region, while at the same time improving the conditions for the development of innovative and high growth SMEs and stimulating the emergence of a venture capital market. The financial components of EDIF will be set up to serve the primary objective, but they will need to be accompanied by reform interventions in the regulatory environment for both, the target SMEs and investors.

To this end, the Beneficiary representatives to the Western Balkan Investment Framework (WBIF) agreed in December 2011 to undertake the reforms necessary to improve the environment for IHGSMEs and for investment funds, in order to achieve the full effect of EDIF on the development of respective markets. The OECD Investment Compact is assisting the EDIF project partners in identifying these reforms prior to the project launching foreseen for December 2012. Using the existing sources of policy assessments from the OECD, the EBRD, the European Commission, the World Bank, the Vienna Institute for International Economic Studies and others, this process resulted in a list of reform suggestions for each beneficiary economy.

The OECD preliminary findings were then refined during expert meetings involving leading scholars and experts on South East Europe, as well as the main donor organizations in the region. The result of this work is a short list of some 20-25 reform suggestions for each beneficiary economy, each of which would be relevant in the context of the EDIF objectives.

At the same time, a mapping of donor activities and projects in the region was conducted. This will enable identifying the gaps where targeted support would be most needed and could subsequently be provided under the EDIF TA component. In addition, targeted IHGSMEs company survey, carried out by the OECD, provides additional empirical analysis on the policy needs of IHGSMEs.

Figure 1 Steps in the policy reform prioritisation process



The document below presents the 20-25 reforms that are the result of the policy reform prioritisation to date. The document is structured around eight policy dimensions that were identified as the most crucial for IHGSMEs. The policy dimensions are presented in order of importance for IHGSMEs. Each policy dimension section starts with a background note and subsequently lists reforms identified through the policy reform prioritisation process. This document is to provide a starting point for the discussion during the roundtable.

The next step is to further prioritise the reforms during the EDIF Stakeholder Round Table. The OECD encourages all meeting participants to assess each identified reform using the following criteria:

- Relevance of the reform for innovative and high growth SMEs;
- Feasibility of the implementation of the reform;
- Added value of the reform for innovative and high growth SMEs;
- Whether similar programmes or attempts to implement the reform are already in place. The database of existing donor projects can be used for this purpose.

The objective of the roundtable is to identify and agree upon a set of priority reforms, which will accompany the implementation of EDIF, supported by its TA component. The discussion should seek to find an agreement on a short-list of maximum three reforms.

OBSTACLES TO BUSINESS

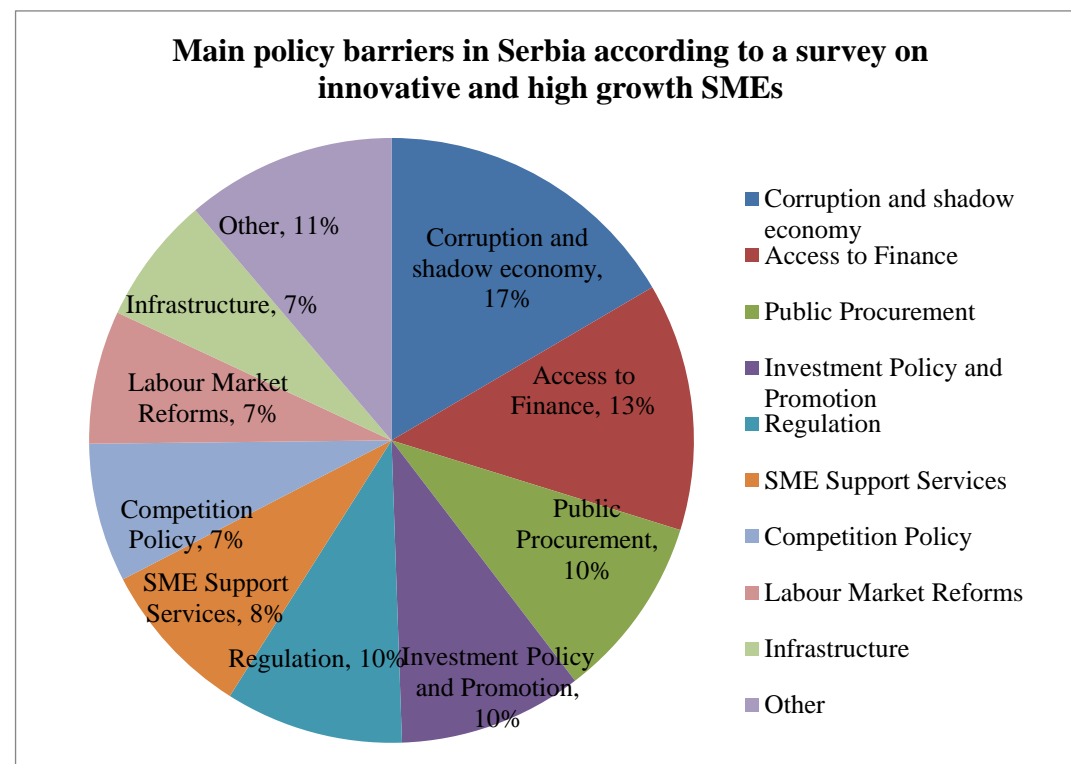
This page aims to highlight what companies identified as the main obstacles to business, based on a survey conducted on innovative and high growth SMEs by the OECD and the Business Environment and Enterprise Performance Survey conducted by the European Bank for Reconstruction and Development and the World Bank.

Table 1. Obstacles to Business. BEEPS 2008. Source: European Bank for Reconstruction and Development and the World Bank, 2010

Relative rank of problems measured by the mean score. The most severe problem ranks number 1, the least 14.	Rank in 2005	Rank in 2008
Corruption	4	1
Access to finance	2	2
Tax rates	1	3
Courts	3	4
Skills and education of workers	9	5
Electricity	14	6
Customs and trade regulations	6	7
Labor regulations	7	8
Tax administration	5	9
Crime, theft and disorder	10	10
Transport	13	11
Business licensing and permits	8	12
Access to land	11	13
Telecommunications	12	14

Figure 1 Main barriers to growth according to a targeted survey of high growth SMEs, determined on a sample of 110 firms who have achieved cumulated growth of 72% over the period 2007-2010. Source: OECD, June 2012

The “other” slice groups human capital, public support for R&D and innovation, intellectual property law and all other answers.



ANTI-CORRUPTION POLICY

Regional Background

Corruption continues to be a serious problem in the SEE region. A number of economies have yet to establish the necessary legislation, enforcement remains weak, and judiciaries and anti-corruption bodies struggle in running robust investigations. To date, actions to eliminate corruption have only been partially successful, and in some economies firms' perceptions of corruption and the sums paid in bribes have in fact worsened. Firms in Serbia rank corruption as the largest obstacle to doing business, with firms in Albania, Bosnia and Herzegovina and Kosovo^{1*} close behind, ranking corruption as the second largest obstacle (European Bank for Reconstruction and Development and World Bank, 2010). Corruption and the shadow economy is the top concern for high growth firms according to the 2012 OECD survey of HGSMs.

The economies in the region, with the exception of Kosovo, have signed the Regional Anti-Corruption Initiative, a framework for political coordination promoting transparency and good governance.

Anti-corruption measures are important to create an environment in which SMEs can grow. Corruption has negative effects on economies more broadly, including reducing competition, effectiveness and innovation, deterring domestic and foreign investment, inducing resource misallocation by firms and, resulting in poor government policies to the detriment of firms. SMEs are particularly vulnerable to these effects. According to the EBRD-World Bank Business Environment and Enterprise Performance Survey 2000 (European Bank for Reconstruction and Development and World Bank, 2010), small firms pay a larger percentage of their revenues in bribes to public officials than medium and large firms, and also have to pay bribes more frequently to do business.

The costs of corruption on SMEs are considerable. Paying bribes and other corrupt practices result in the misallocation of resources to non-productive activities. In addition, because firms engage in rent-seeking activities, they do not react to market signals, leading to reductions in competition, efficiency and innovation. Additionally, corruption limits domestic and foreign investment as investors are put off by high risk, weak rule of law, and unpredictable costs (Centre for International Private Enterprise, 2011).

Economies in the region should consider enacting reforms to strengthen the capacity of anti-corruption bodies, the judiciary, enforcement agencies, and public procurement bodies, both to ensure their independence and improve efficiency. Economies should also establish comprehensive legislation (particularly lacking in the Macedonian and Serbian economies), ensure its enforcement, and consider bringing public procurement legislation in line with the EU *acquis*.

In order to create a favourable environment for SME's, governments should pay particular attention to anti-corruption efforts when dealing with courts, customs and tax administrations, obtaining licences and permits, and public procurement procedures. More generally, the capacity of SME's to address issues of corruption should be strengthened; SME's do not have the necessary resources and time to obtain legal help in cases of corruption. Therefore, governments could envisage creating hot lines for SME's and providing free legal advice for corruption matters.

¹ * This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo declaration of independence.

In addition, competition from the informal sector poses a problem for many businesses in the formal sector. Countries should start or continue implementing measures to reduce the informal sector.

Within anti-corruption policy, the overall areas perceived as most problematic for IHGSMEs by leading scholars and experts at a meeting in Paris were: 1.) Transparency of public procurement (e-procurement), 2). Minimize discretionary decision-making (e-government), 3). Corruption on the border.

Reforms

Overall, corruption continues to affect many areas, particularly public procurement, privatisation procedures and public expenditure, as well as the health and education sectors. The 2008 BEEPS survey showed that reported bribe frequency affecting firms remained at somewhat higher levels than the SEE and ECA averages. The bribe tax for firms that admitted paying bribes more than doubled to 4.1 percent of annual sales in 2008, indicating a growing tendency toward grand corruption (Global Integrity, 2011).

Judicial system / corruption when dealing with courts

Proposed reform 1: Strengthen the capacity and integrity of judicial institutions in order to enhance law enforcement and execution of judgements

The lack of judicial independence constitutes a strong competitive disadvantage for companies in Serbia. The system of law enforcement in both commercial courts and courts of general jurisdiction functions poorly.

Enforcement officers face overwhelming caseloads with inadequate resources and poor institutional support, resulting in long delays, ineffective performance, and a tendency towards bribery to facilitate favourable proceedings and outcomes. (World Economic Forum, 2011)

Licences, public utilities, etc

Proposed reform 2: Improve the transparency of procedures for obtaining business licenses and public utilities

Companies doing business in Serbia report that corruption is common in the processes of obtaining necessary business licences and permits. SMEs experience irregularities and corruption when dealing with public officials. Problems are worse for those companies operating in smaller municipalities where public administration capacity is lower. (Trivunovic, Devine and Mathisen, 2007)

Of the business executives surveyed, almost one-third of the responding companies expect to bribe in order to get an electricity connection while the numbers for those who expect to give bribes to get access to water and telephone connections are lower. (World Bank & IFC, 2009)

Tax Administration and corruption

Proposed reform 3: Ensure proportional penalties for tax offences

Companies should note that irregularities exist in the tax regime, particularly the disproportionately high penalties imposed on companies even over minor offences. For example, if a business is unable to immediately provide certain certificates, it can be punished with immediate closure, and there are substantial difficulties associated with re-opening later. (Global Integrity, 2011)

The informal economy

Proposed reform 4: Further efforts to reduce the size of the informal sector. Reforms to be determined.

Main motivations for entrepreneurs to participate in the informal economy include tax evasion, maintenance of government benefits for unemployed, circumventing regulation and licensing requirements, neutralising labour union influence and reducing impact of international competition (Gërzhani, 2004). The informal economy mostly develops in times of recession as the unemployed seek to participate in the informal economy. Transition to the formal economy can be achieved by reducing these incentives and/or by increasing the probability of being detected and punished. Very severe sanctions of the informal economy may cause negative effects on employment, worsening the economic condition of the most fragile part of the workforce. This reform must therefore be fine-tuned for optimal impact. A soft component such as a communication campaign to create peer pressure may be a good start.

Serbia established a Market Inspection Sector with a network of 400 market inspectors, located in 25 districts in Serbia (OECD, 2012). The informal economy is quite large: more than half of Serbian firms face competition from unregistered or informal firms (OECD, 2010). According to estimates, up to 1 million people are working in the informal economy (European Commission, 2011). The EC progress report attributes the informal sector to weaknesses in tax and expenditure policies and in law enforcement.

ACCESS TO FINANCE

Regional Background

Access to finance is a concern for firms in the SEE region. In a 2012 OECD survey of high growth SMEs, access to finance was highlighted as a very important barrier, second only to corruption. In the general population of SMEs measured by the BEEPS study in 2008, it was the number one concern with over 45% of SMEs citing access to finance as a moderate to severe obstacle to doing business.

Banking institutions remain dominant, representing between 40% and 80% of external funds for the purchase of new equipment (European Bank for Reconstruction and Development and the World Bank, 2010). This dominance is due to both the rapid growth of the banking sector and the poor development of equity finance. Mechanisms to ensure that lenders and investors have reliable and timely access to information regarding the credit worthiness of companies are being developed. Nevertheless, a number of issues are outstanding in the region. Collateral requirements for credit remain high in the SEE region, for instance, banks in Kosovo require 150% to 200% of a loan amount as collateral (OECD, 2012).

Access to alternative sources of finance is also limited in certain economies. Dedicated credit lines for SMEs have been set up in most economies of the region; however these are limited in scope. Factoring and leasing agencies are emerging across SEE and microfinance institutions are fairly well established (except in Croatia) and have a positive impact. Credit and export guarantee schemes vary in quality across the region, ranging from well-developed programmes in Croatia to no such provisions at all in Kosovo.

The countries in the region do not have the framework for business angel and venture capital investments including a sound protection of minority shareholders' rights. Perhaps as a consequence of this, only a very limited number of venture capital funds operate, with Croatia offering the most conducive environment for VC funds. Business angel networks are even scarcer.

On the demand side, financial reporting and investment readiness are important issues in South East Europe. Sound financial reporting breeds trust, which in turn makes lending possible. SMEs need tools and skills to improve financial reporting in order to make it possible to envisage cash-flow based lending, rather than collateral-based lending which largely dominates today. In addition, entrepreneurs need improved strategy, finance and marketing skills to be able to present bankable business plans which will make their projects investment ready, i.e. attractive to equity investors.

Within access to finance, the overall areas perceived as most problematic for IHGSMEs by leading scholars and experts at a meeting in Paris were: 1) Investment readiness and financial reporting, 2) attracting private investors and investors from the Diaspora, 3) credit guarantee schemes for innovation and for exports, 4) taxation of capital gains and regulations for venture capital investment schemes.

Reforms

Proposed reform 5: Put in place legislation for venture capital and private equity funds

The review of the legal framework for the operations of venture capital and private equity funds should be part of an IPA project to be implemented in 2012

Currently, there are no specific regulations in the field of venture capital/private equity funds. (OECD, 2012).

Proposed reform 6: Provide support to the Business Angel Network

Further support could be provided to the network by using tax incentives for capital gains, stimulating cooperation between angels and other investors, and potentially using public funds to enlarge BAN's seed capital pool.

The business angel network of Serbia began operating in 2010. The establishment of the BAN is a completely private initiative which has not received institutional support. It is not included in any government programme to encourage the development of this type of investments. (OECD 2012)

Proposed reform 7: Improve the regulatory framework for venture capital investment schemes.
Particularly, enhance the protection of minority shareholder rights.

Serbia has scored 5.3 out of 10 since 2006 on the Doing Business strength of investor protection index.

Proposed reform 8: Implement policies to attract Diaspora investors.

Governments and international agencies could facilitate investment networks. A regional initiative could be envisaged to have economies of scale. Policies could include the creation of a network between domestic and diaspora business angels or the creation of a web platform to enable peer evaluation of promising projects.

Proposed reform 9: Increase the investment readiness of entrepreneurs.

A consistent programme should be considered to improve the investment readiness of entrepreneurs.

INVESTMENT POLICY

Regional Background

Investment policy reforms have been undertaken by all economies of the region. Since 2008, one of the most successfully implemented reforms has been the introduction of the one-stop-shop. By short-circuiting lengthy administrative procedures and providing investors with a single point of contact, the one-stop-shop has facilitated and accelerated investments. Other recent measures aimed at improving investment climate in the SEE region have dealt with streamlining procedures for attaining licenses and permits and improving enforcement of intellectual property rights.

Two additional priority areas identified by the expert panel during the EDIF Policy Assessment meeting should also be considered for future investment policy reform. These areas are streamlining bankruptcy procedures and better enforcement of contracts.

Laws on bankruptcy procedures are generally in line with international standards in most economies in the region with the exceptions of Albania. On the other hand, none of the economies in the region have addressed the issue of promoting second-time entrepreneurs. Campaigns to address the negative image of entrepreneurs who were not successful in their first businesses for reasons other than fraud should be considered. Future bankruptcy reforms should also take into account the hurdles that second-time entrepreneurs face when trying to access finance.

Facilities to enforce contracts efficiently can significantly encourage foreign investment. Research has also shown that efficient contract enforcement can result in greater access to credit for firms (Doing Business). In many countries in the region, small claims courts and alternative dispute resolution mechanisms are scarce or non-existent. Progress was seen in the countries, which established an electronic case management system, facilitating contract enforcement in commercial matters. Similar measures, as well as the establishment of small claims court, should be considered by all countries in the region.

The overall areas perceived as most problematic for IHGSMEs by leading scholars and experts at a meeting in Paris were: 1) bankruptcy procedures and costs, 2) the enforcement of contracts and an efficient court system for small claims, 3) the use of internal best practices to reduce regional disparities for administrative procedures.

Reforms

Proposed reform 10: Improve bankruptcy procedures, specifically by strengthening the efficiency of courts and further implementing a system of out-of-court agreements

The authorities have initiated actions to regulate out-of-court settlements in order to lower the cost and speed up the privatisation process, however further implementation is needed to help decrease the high number of backlogged cases.

A new bankruptcy law entered into force in 2010 which has overall helped improve market exit procedures. Nevertheless, the efficiency of the courts remains an issue of concern in view of the considerable backlog of bankruptcy cases (European Commission, 2011). The new law establishes automatic bankruptcy in cases where the firm's accounts have been blocked for more than three years. This has resulted in a significant increase in the number of opened cases. (World Bank, 2012 and OECD, 2012).

Proposed reform 11: Launch a campaign to avoid discrimination of entrepreneurs who went through bankruptcies and did not commit fraud

Measures to systematically recognise honest vs. dishonest entrepreneurs should be considered. Policies that allow honest entrepreneurs quicker liquidation and discharge procedures could encourage re-starters to enter the market sooner. Suitable financing solutions for re-entrepreneurs should also be considered. However, to avoid moral hazard, policies must be careful to find a balance between debtor's interests and those of the creditor.

There has been no campaign to avoid discrimination against entrepreneurs who went through bankruptcies and did not commit fraud. (OECD, 2012) A second chance policy that enables formerly bankrupt entrepreneurs to re-enter the market can present a significant opportunity for company creation and job growth.

Research shows that businesses set up by re-starters grow faster than businesses set up by first timers in terms of turnover and jobs created. (Stam et al 2006)

Proposed reform 12: Improve public procurement procedures. In particular, a consistent policy approach to address late payments is needed.

The framework for public procurement is relatively well advanced. Public procurement is split into lots and the law ensures that SMEs are given proportionate qualification levels and financial requirements. While there is no e-tendering, it is envisaged for the future. The lack of law to combat late payments remains an issue as, despite attempts to combat them, there has been no consistent policy approach. The Ministry of Economy and Regional Development is finalising a decree to regulate late payments to the public sector. (OECD, 2012)

HUMAN CAPITAL DEVELOPMENT

Regional Background

The European Union has agreed to aim for an employment rate of 75% for the 20-64 years age group by 2020. A skilled workforce is an essential asset to develop a competitive, sustainable and innovative economy in line with Europe 2020 goals.

Human capital development has also become one of the policy priorities in Western Balkan economies. In the area of higher education and vocational training, several reforms were implemented and relevant institutions were established. All economies have recognised the importance of developing strategies related to Human Capital Development with the overall objective of decreasing unemployment, especially among the youth, and to prevent mismatches between labour supply and demand. In particular, several Western Balkan economies have developed or are currently working on a strategy for lifelong and entrepreneurial learning. All the Western Balkan economies, with the exception of Kosovo, take part in the European Bologna process.

However, Human Capital Development remains a challenge in the region, as shown by the very high unemployment rate among the youth and low employment rates more generally. “Brain drain” is strong in all Western Balkan economies, and policies to retain and attract qualified and skilled individuals need to be further developed. In addition, adult education should become a policy priority to avoid further deterioration of skills of the labour force. Another priority should be to increase the quality of education, with special attention to its relevance on the labour market- the mismatch between labour supply and demand is still significant. Finally, to better understand the current situation on the labour market, data development and data analysis should be improved.

A key driver of high growth SMEs in the Western Balkans is likely to be the quality of their employees provided that they have the knowledge, skills, motivation and entrepreneurial capacity to work in a challenging environment. Promoting enterprise activity in higher education and VET is therefore of particular interest for high growth SMEs. Another important aspect of human capital for high growth SMEs is the availability of adequate training programmes (lifelong learning) to obtain a skilled workforce capable of contributing and adjusting to technological change and new patterns of work organisation.

Generally, Western Balkan economies have to address the issue of skills gaps between educational institutions and employers and promote lifelong learning in order to develop a skilled workforce that can respond to the rapidly changing labour market needs. The performance of education and training systems at all levels needs to be improved, and the participation in tertiary education increased. Investment in education and training systems, anticipation of skills needs and matching and guidance services are the fundamentals to raise productivity, competitiveness, economic growth and ultimately employment.

Within human capital development, the overall areas perceived as most problematic for IHGSMEs by leading scholars and experts at a meeting in Paris were: 1) technology and industry specific skills, 2) monitoring teaching quality and educational outcomes, 3) incentives for vocational training in firms, 4) financing secondary education.

Reforms

Proposed reform 13: Further align vocational education and training with labour market needs

The Serbian VET system needs further reforms to improve the quality and the labour market relevance of vocational education (European Commission 2011). The mismatch between qualifications and employers’ needs remains a challenge in the fight against unemployment. In order to better respond to businesses’

needs and narrow skills mismatches, curricula have to be updated and in line with private sector requirements. The objective is to encourage the inclusion of business and entrepreneurship courses, particularly in university curricula (e.g. teaching about starting up a new business, training in advanced management skills and business leadership). Teaching methods also need to become more student-centred. (European Commission, 2011)

Proposed reform 14: Strengthen life-long learning and adopt a law on adult education

- (i) Improve access to adult learning and continuing training to all categories of adults and especially for unemployed.
- (ii) Empower VET and AE Council to ensure effective articulation of the demand side of adult learning.

Lifelong learning and adult education are in the early stages of reform and a law on adult education remains to be adopted (European Commission, 2011). Recent statistics from the World Bank about the percentage of firms offering formal training to employees reached 39.5% in Serbia, less than Slovenia (62%), Croatia (47.8%) or Bosnia and Herzegovina (42.4%). Capacity for continuing vocational training is still very small and the emphasis in policy thinking is mainly on adult education, including legal and institutional issues, capacity building, accreditation and quality control, and the need to establish a wide network of providers.

Proposed reform 15: Conduct regular assessments of skills gaps and incorporate the results in medium and long-term education and training strategies

Improvements in skills gap measurement and other human capital data collection are needed to support policy making.

Major skills gaps persist in Serbia. Medium and larger companies have had better access to the training on offer, so extra effort is required to ensure training is more available to small businesses. This will be particularly important for small businesses trading in sectors that will be highly exposed to competition within the EU internal market. (OECD, 2012)

Proposed reform 16: Enhance the quality assurance system for training providers

The improvement of quality assurance mechanisms at all levels of education and developing a national qualifications framework remain an important challenge for Serbia (European Commission, 2011 and OECD, 2012)

A high-quality teacher workforce is crucial for the performance of education and training systems as a basis for future global competitiveness. Of the same magnitude are the professional capacities of school principals in VET and adult education. In 2006 the Vocational Education Development Strategy was adopted. However, the implementation is slow - less than half of VET schools have participated in VET reform. PISA and TIMSS results point to the lack of standards regarding the quality of the teaching process and the teachers themselves (ETF, 2009).

A study of Serbia's results in the PISA tests points out that performance of 15 year old students in three surveyed domains (mathematical, scientific and reading literacy) is significantly below the OECD average

and also lower than the performance of students in Croatia and Slovenia (mostly in the domain of the reading literacy).

INNOVATION

Regional Background

The economies in the region are at different stages of development of their innovation framework. For example, while Serbia and Croatia are amongst the most advanced economies in the region with regards to innovation policy (OECD, 2012), Kosovo's innovation policy remains in its infancy. At a ministerial conference in November 2011, the economies agreed to make smart growth a pillar of the SEE 2020 strategy thereby committing to improving their innovative capacity.

Improving the innovation system and more particularly knowledge flows within the economy is key to enabling high growth SMEs to innovate and become more competitive both on the regional and on the world market.

Innovation in the private sector can include both non-research based innovation, and the development and commercialisation of research. For instance, despite low spending on research and development, spending on non-R&D innovation are higher than in the EU (European Commission Directorate for Enterprise and Industry, 2011) and companies do innovate. It should be kept in mind that there is room to improve innovation in all sectors, including innovations in the service sectors and innovation in the public sector.

While innovation can occur on many scales and in different sectors, improving innovation systems nevertheless requires funds, often lacking in the region. Funds should however be carefully spent on relevant policies and avoid focusing solely on "upstream" innovation at the expense of "downstream" innovations which can reduce costs. The effectiveness of existing measures should also be assessed to ensure their relevance.

In addition, South East Europe remains characterised by the lack of linkages, including both national and international linkages, between the research community and businesses. Because business expenditure on research and development (BERD) is also very low across all these economies, businesses do not perform much research of their own either. This hinders the development of research-based innovation and also results in an inefficient allocation of research funds.

Reforms across the region should focus on increasing linkages on a national and an international level, across the research community, the business community and governments.

Economies such as Serbia have already defined an innovation strategy while the OECD has conducted an assessment of the Macedonian innovation system that is leading to a strategy. For these economies, it is important to ensure that they dedicate the necessary funds for the envisaged reforms and that sufficient prioritisation takes place to make the implementation of the strategy feasible and realistic.

The overall areas perceived as most problematic for IHGSMEs by leading scholars and experts at a meeting in Paris were: 1) Support to product improvement (ISO standards, engineering, software, cooperative (non R&D) innovation projects), 2) Technology transfer from university and from abroad, 3) Capacity for innovation of companies, 4) Funding for innovation strategies/inter-ministerial coordination.

Reforms

Proposed reform 17: Implement policies to increase the capacity and readiness for innovation in companies

Innovation goes beyond technology and includes new organisational methods and marketing innovation. Policies to increase the capacity and readiness for innovation should address all types of innovation.

Policies could include entrepreneurship classes in universities, programmes to raise awareness on innovation, innovation voucher schemes, innovation grants or cooperative PhDs.

The Serbian government places a strong emphasis on science and technology (OECD, 2011); measures to develop other types of innovation should be developed further. There is room both to further encourage product and process innovations and to develop policies to promote marketing and organisational innovations that can also significantly increase competitiveness.

R&D activities in the business sector tend to remain marginal. Indeed, only 14% of R&D is undertaken in the business enterprise sector (OECD, 2011). In addition, the structure of the Serbian industry is dominated by inward-looking SMEs with low absorptive capacities and unsophisticated production processes (OECD, 2011).

Proposed reform 18: Provide higher value-added support for SMEs and start-ups

In addition to providing mainly basic services, business incubators could increasingly provide high-quality services and innovation support to new, science-based companies.

According to OECD calculations, only 3% of Serbia's manufacturing exports are high technology products; this share is lower than in Croatia, Bulgaria and Romania (OECD, 2011).

Serbia has developed a range of support services for SMEs and start-ups which are still oriented toward low-value added support.

Proposed reform 19: Devise a strategy for the decentralisation of business parks.

The following points should notably be taken into account:

- Are the business parks accessible to SMEs? Are they in a place where there is a "critical mass" making the infrastructure appropriate?
- Are the services provided relevant for SMEs (if it aims to target SMEs)? Are they demand led?
- Is the funding the business parks/ incubators sustainable?
- Are the regulatory aspects of the service appropriate and in line with its objectives?
- What measures are put in place to address brownfield locations?

Particular attention should be paid to the relevance and sustainability of business incubators and other business support services. (see Mijacic, 2011)

The Serbian government supports investments in innovation infrastructures. The main sources of finance for these projects are international financial institutions such as the European Investment Bank, the EBRD and the World Bank. An infrastructure investment initiative of 400 million Euros covers the 2010-2015 period and includes the construction of science parks (OECD, 2011).

There is no central register of business support infrastructure in Serbia. It is estimated that there are about 92 industrial zones, 2 existing and 4 planned technology parks, 85 cluster initiatives and 23 business incubators in the country. In addition, there are about 66 brownfield locations, areas which have lost their purpose or become under-used.



with the financial support
of the European Union

There is insufficient cooperation between industrial zones, business parks, regional development agencies, chambers of commerce and other institutions (Mijacic, 2011).

TRADE POLICY AND FACILITATION

Regional Background

Western Balkan economies are making progress in strengthening their ties with the multilateral trading system and in deepening intra-regional trade. Economies that are still not members of the WTO are advancing in their negotiations, a number of symmetric trade arrangements with the EU entered into force, and a lot of achievements have been made through the implementation of the CEFTA Agreement (for instance, full tariff liberalisation has been achieved between the Parties on trade in industrial products). Furthermore, levels of applied tariffs for agricultural and non-agricultural products are adjusted to the world average, and the regimes for other non-tariff measures such as licenses and quantitative restrictions are in line with standards typical for OECD economies.

The implementation of an open and liberal trade regime is an important element that contributes to economic growth and to attracting investment. In particular, trade liberalisation has a positive effect on productivity, because trade-related competition allocates resources towards more efficient and innovative enterprises. Opening up to international competition will not only induce increased efficiency in domestic firms but it will also stimulate their exports. This is of an importance as exporting firms are more productive and experience higher technological growth.

To support SME's internationalisation, Western Balkan economies should focus in particular on reforms in the following areas:

Non-tariff barriers to trade

Western Balkan economies should support the establishment of a network of independent conformity assessment bodies to facilitate certification for local firms, especially SMEs.

The use of standards among companies needs to be promoted, with the aim of boosting export competitiveness. Unfamiliarity with European standards is a major obstacle to placing goods on European markets. (OECD, 2010 & CEFTA NTBs report)

The majority of the economies (with the exception of Croatia and FYROM) should speed up the adoption of the EU sectoral acquis for industrial products (both Old Approach and New Approach).

Export promotion

Capacities of Western Balkan's export promotion agencies (EPAs) should be strengthened (with the exception of Croatia and Serbia whose EPAs are fully operational). This could be done by increasing the budget allocations for export promotion agencies, along with consistent adoption of documented best practices. (OECD, 2010)

As most of the economies have export promotion programmes in place (with the exception of Bosnia and Herzegovina and Kosovo), **it is crucial to offer a variety of services to export-oriented SMEs**, according to their needs and allocate sufficient funds for their realisation. **All economies should set up monitoring and evaluation mechanisms to make it easier to assess the effectiveness of export promotion programmes.** (OECD, 2012)

Within trade policy and facilitation, the overall areas perceived as most problematic for IHGSMES by leading scholars and experts at a meeting in Paris were: 1) standards and conformity assessments capacity, 2) export capacity (SME networking and clusters), 3) Building institutional for certification, 4) industry specific export promotion programmes and 5) tax policy as a substitute for trade policy (fiscal devaluation).

Reforms

Proposed reform 20: Reduce technical barriers to trade

Standardisation / accreditation

With respect to technical barriers to trade, Serbia will need to strengthen its network of standardization and certification bodies. The capacities of both the Institute for Standardisation and the Accreditation Board should be improved as a way of supporting exporters. The adoption of sectoral *acquis* for industrial products could be sped up. (OECD, 2010 & CEFTA NTBs report)

Certification / standards

Further assistance should be provided to companies, especially SMEs, to apply for certification and to implement EU/international standards. Unfamiliarity with European standards is a major obstacle to placing goods on European markets. A specific effort should be done in the translation process of EU/ISO standards into Serbian language. (OECD, 2010)

Serbia has taken some important steps in tackling technical barriers to trade. In the area of standardisation, important achievements include the establishment of the Institute of Standardisation as a non-profit organisation in 2007, as well as adoption in 2009 of new laws on standardisation, general product safety, technical requirements for products and conformity assessment. Some progress has also been noted in the area of accreditation.

TAX POLICY AND ADMINISTRATION

Regional Background

Many tax issues are relevant for innovative and high growth SMEs. These include the tax treatment of SMEs, the tax treatment of returns on equity, the tax treatment of innovation and R&D, the change in the tax treatment of a company as it grows and potentially changes status, and the extent to which tax incentives erode the tax base and whether they achieve their initial goal. The tax treatment of multinational companies also affects SMEs which have to compete against these companies.

With a few exceptions, the economies of South East Europe have not analysed tax issues pertaining to SMEs specifically. Albania and Kosovo have examined the consequences of double taxation on the distribution of profits and investments. More generally, Kosovo is ahead of the region in assessing tax issues specific to SMEs.

The region also lags behind on tax administration. For example, it takes 371 hours on average to file taxes in Albania, 302 in Eastern Europe and Central Asia and 186 in the OECD. The number of payments per year is also very high.

Lengthy procedures to pay taxes can be particularly burdensome on SMEs as these firms tend not to have the administrative capacity to deal with these procedures specifically. Simpler procedures can also increase compliance.

To improve the performance of the tax system, the economies should above all focus on easing tax procedures. This would reduce unnecessary administrative costs, which can burden SMEs in particular. The countries should also assess some of the issues pertaining to innovative and high growth SMEs and in particular the tax treatment of capital gain and the tax treatment of innovation.

The overall areas perceived as most problematic for IHGSMEs by leading scholars and experts at a meeting in Paris were: 1) Tax treatment of capital gains, 2) tax treatment of innovation and 3) the simplification of procedures

Reforms

Proposed reform 21: Streamline tax payment procedures

The administrative burden of paying taxes remains a major constraint for businesses. Indeed, Serbia ranks 143rd on the Paying Taxes dimension of the Doing Business Report because of numerous tax payments and time-consuming procedures (World Bank, 2012).

Proposed reform 22: Ensure that the tax treatments of capital gains do not deter investment by venture capital funds, private equity funds and business angels.

The fiscal treatment of venture capital gains should notably acknowledge the high risk faced by investors.

Proposed reform 23: Evaluate the costs and benefits of R&D tax credits, in particular in comparison with other incentives for innovation such as innovation vouchers or matching grants.

An R&D-related tax incentive in Serbia targets non-profit R&D organisations. These organisations are not required to pay taxes for the R&D services they provide to customers under non-profit contracts (OECD, 2011)

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