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Country Report

SME SECTOR DEVELOPMENT BY IMPROVING FINANCIAL SUPPORT: SERBIA COMPARED TO OTHER SEE COUNTRIES

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Abstract
Expectations of the SME sector in Serbia are high but the position of this section of the Serbian economy is made difficult by numerous obstacles. The existing fiscal and administrative framework is not stimulating and there is a lack of adequate financial support. Therefore, it is necessary to provide a better business environment through access to financial resources, tax incentives, cheaper and faster start–up procedures, development of an institutional basis for representation of SME interests, and creation of educational and training programs for entrepreneurship. The most important financial institutions whose establishment and functioning should be encouraged are: investment companies, micro-finance institutions, venture capital funds, and local development and credit companies.

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1. Introduction

In all former socialist countries, the last decade of the 20th century was marked by reforms and transition to a market economy. In all countries in transition, the process of political and economic transformation is based on the development of the private sector and entrepreneurship, as well as on the creation of conditions for the establishment and development of small and medium-sized enterprises. Small and medium-sized enterprises (SMEs) are considered to be one of the principal driving forces in economic development of every country.[1] SMEs stimulate the development of the private sector and entrepreneurial skill, display flexibility and adjustability to market trends and demands, create new jobs for a large number of unemployed, enable a diversified economic structure, contribute to an increase in exports and trade; in a word SMEs take an active part in the creation of a market economy.

However, apart from recognizing the significance of the SME sector for economic development, it is also necessary to make an additional effort to create an adequate environment for this economic sector. Despite evident progress, the environment and macroeconomic situation in Serbia are still not such as to enable the further accelerated development of the SME sector and entrepreneurship.

The basic idea of this paper is to point to the significance of the SME sector for the establishment and promotion of a market economy, as well as to the major limiting factor in its further development - the scarcity of funds. By pointing to alternative solutions that enable broader access to financial sources, the paper presents to the economic policy makers in Serbia the directions to be taken so as to improve financial support to the SME sector.

2. SME Sector Development

2.1 SME Sector Development in Serbia

The beginnings of SME sector development in the territory of the former Yugoslavia go back to the late 1980s and early 1990s, when the Federal Government implemented a set of measures designed to increase the competitiveness and efficiency of the economy, as well as to enable trade liberalization and the establishment of a legal framework for the formation of joint-stock companies and privatization of existing enterprises. In order to fill in the "socialist black hole",[2] measures were initiated geared to the development of new, private SMEs and the privatization and restructur-

1. Under Serbia's current Accounting Law (*Official Gazette of the FRY*, No. 71/02), medium-sized legal entities are those legal entities which meet at least two of the following three criteria: 1) the average number of their employees is 50-250; 2) total annual revenue is € 2.5-10 million and 3) the average value of their assets is € 1-5 million. If these figures are lower in the case of at least two criteria, legal entities are regarded as small-sized enterprises.

ing of state-owned enterprises. In an attempt to develop an institutional infrastructure that would support such measures, the Government set up the Agency for Small and Medium-Sized Enterprises and Entrepreneurship. These measures started to produce results: during a period of three years, more than 180,000 private SMEs were established and more than 10% of socially owned enterprises embarked on the process of privatization, raising expectations that the process would be finished much before the expiry of the anticipated ten-year period.

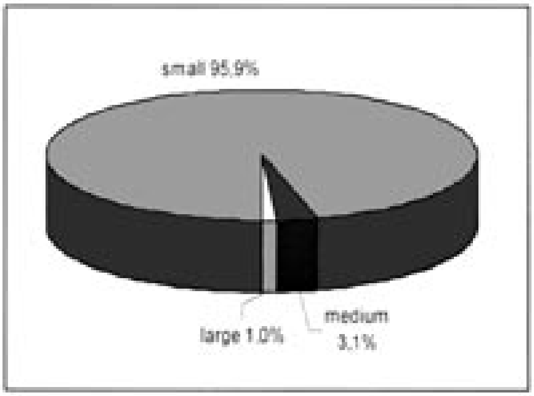
However, after the collapse of the former Yugoslavia, the new state did not continue this policy of support for SME sector development. For this reason, the experience of the domestic economy relating to further SME establishment and development differs from that of other countries. In contrast to developed economies, where the basic problem was how to reallocate capital so as to improve economic efficiency, while at the same time "disassembling" large systems into more profitable units, the Serbian model was not based on the restructuring of inefficient, insolvent and poorly managed enterprises. Instead, large systems were kept operating artificially by implementing various economic policy measures. Thanks to a soft budget constraint, large systems were characterized by the highest concentration of capital and labor, the largest amount of unpaid debts, outstanding tax liabilities, etc. The extremely small number of SMEs was operating with minimum initial capital and without any chance to gain access to cheaper sources of finance. A "contribution" to such neglect of the significance of the SME sector was also made by ideological bias and administrative discrimination against private SMEs, thus additionally increasing the risk of investing in this sector.

The situation began to change after the democratic changes in the country. The new Government, constituted at the beginning of 2001, succeeded in initiating the process of reforms by adopting new system-related laws and implementing comprehensive economic policy measures. Having recognized the significance of private ownership and the SME sector, attempts were made to develop an institutional infrastructure, adopt the relevant laws and regulations[3] and create an environment that would support the development of entrepreneurship. Thanks to these efforts, economic activity has been revived; the privatization process is being intensified, while small and medium-sized enterprises are setting out to win their market share. The following graph and table show the state of the SME sector in Serbia in 2003 and their main performance results in the previous four years.

2. The "socialist black hole" is defined as the gap between the predominance of large enterprises, on one side, and the absence of small and medium-sized enterprises, on the other.

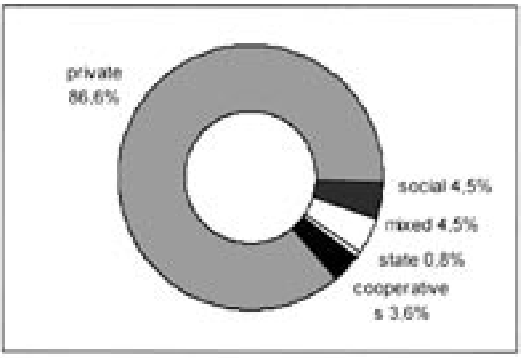
3. The laws concerning the Agency for the Development of Small and Medium-Sized Enterprises and Entrepreneurship and the Privatization Agency were adopted and those institutions were set up; the Ministry of Economy and Privatization, including the Department for SME Development and Department for Private Entrepreneurship, was established, etc.

Graph 1. Number of enterprises by size in 2003



Source: Republic Development Bureau, The *Spring Report*, May 2004, No 5

Graph 2. Number of SMEs by ownership in 2003



Source: Republic Development Bureau, The *Spring Report*, May 2004, No 5

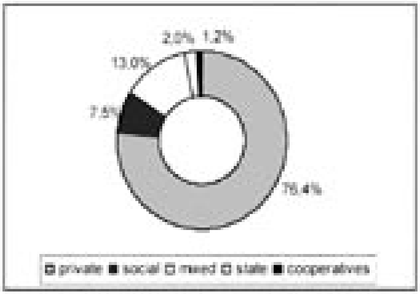
Compared to 2001, the number of active enterprises in Serbia increased 5.8% (2,011). Only small enterprises registered an increase in the number of active enterprises (2,176). The number of medium size enterprises decreased by 89 and large by 76. The main indicators of condition and development level of SMEs show that SMEs are an important part of overall Serbian economy, have an increasing share in the economic structure and are continuously increasing their share of GDP.

Table 1. Main performance results of SMEs in the period 2000-2003

* in mil €	2000		2001		2002		2003	
	total	share in economy (%)	total	share in economy (%)	total	share in economy (%)	total	share in economy (%)
No of enterprises	61,722	98.5	63,985	98.3	66,133	98.9	68,220	99.0
No of employed	623,013	44.6	590,308	43.1	672,969	51.7	668,722	54.2
Fixed assets	4,141	21.1	5,359	20.0	8,503	29.1	9,388	33.0
Capital	5,351	20.8	6,735	19.5	10,545	28.2	11,173	31.0
Total revenues	10,465	34.7	11,852	41.0	16,716	47.6	17,998	51.2
Export revenues	166.7	31.9	492.8	25.6	747.1	33.3	885.9	39.9
Profit	134.7	54.7	202.7	43.5	390.4	44.1	472.7	45.5
Loss	548.4	10.7	363.1	21.0	718.9	46.6	829.4	43.5
Cumulative loss	1,239	13.0	1,582	12.8	2,651	21.1	2,831	26.0
Average ex. rate (€)	58.6750		59.7055		61.5152		68.3129	

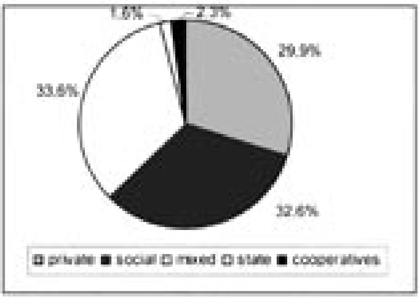
Source: Republic Development Bureau, The *Autumn Report*, October 2004, No 10

Graph 3. SMEs profit structure on average in the period 2000-2003



Source: Republic Development Bureau, The *Autumn Report*, October 2004, No 10

Graph 4. SMEs loss structure on average in the period 2000-2003



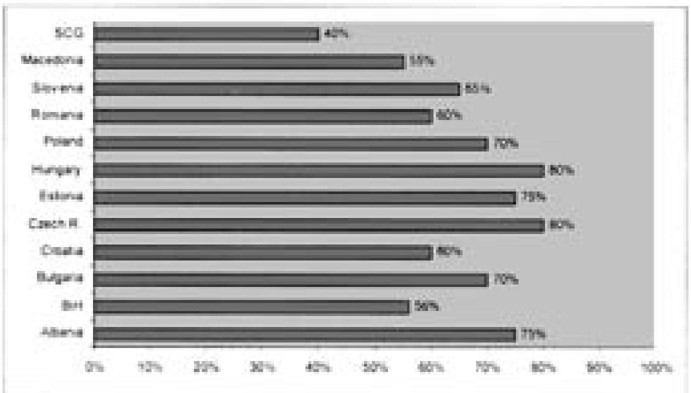
Source: Republic Development Bureau, The *Autumn Report*, October 2004, No 10

Analyzed by type of ownership, privately owned SMEs, which constantly increased their share in total income, exports and profit in SMEs, made the largest contribution to the positive results in SMEs in the period 2000-2003. In 2003 they were dominant in the SME structure according to all indicators, except loss and cumulative loss. The share of loss made in privately-owned SMEs in the total loss made in SMEs decreased from 46.1% in 2000 to 25.1% in 2003, and profit was increased from 65.5% to 82.7 respectively.

2.2 Comparative Analysis of the Level of SME Development Relative to Other Countries in Transition

Although the progress made so far is encouraging, a comparative analysis of the state of the SME sector relative to other countries in transition shows that it is still necessary to make strenuous efforts to create more favorable conditions for SME sector development in Serbia. This is best evidenced by the comparative analyses shown by the following graphs. Our analysis begins with the survey of the private sector's share in the overall economic structure. It can be observed that the private sector's share in the overall economy is much more than 50% in those countries which embarked on the process of transition - that is, privatization - earlier (Hungary, the Czech Republic and Poland). High efficiency and an increased level of productivity characterize the privatized sector of the economy. In that sense, Graph 5 confirms the current situation in the domestic economy: the low share of the private sector in the overall economy corresponds to the low level of productive activity. It also confirms the problems of insufficient efficiency and productivity Serbia is now facing.

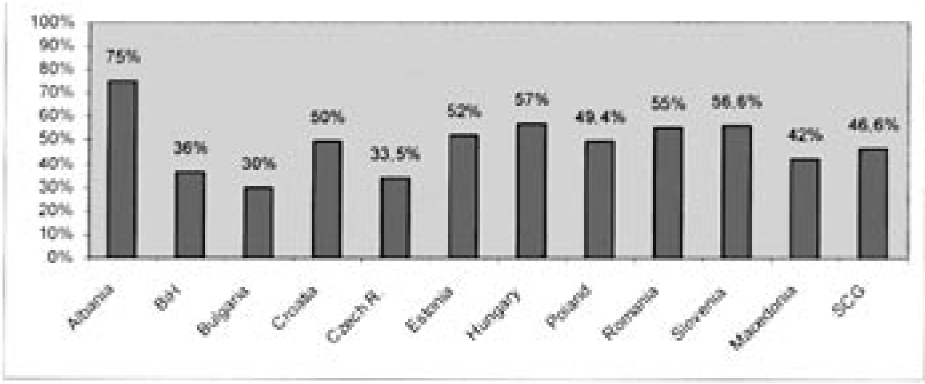
Graph 5. The private sector's share in the overall economy, 2001-2002



Source: UNECE, 2003, *Small and medium size enterprises in countries in transition,* New York and Geneva

However, the next graph gives cause for hope, since it shows that Serbia is not lagging much behind other countries in transition with respect to the contribution of the SME sector to the country's total GDP. Bearing in mind that the reforms in Serbia were initiated in 2001 and that the attempts to create a favorable environment for the SME sector started only then, it is encouraging to learn that the current number of SMEs can generate about 47% of GDP.

Graph 6. Contribution of the SME sector to total GDP, 2001-2002



Source: UNECE, 2003, *Small and medium size enterprises in countries in transition,* New York and Geneva

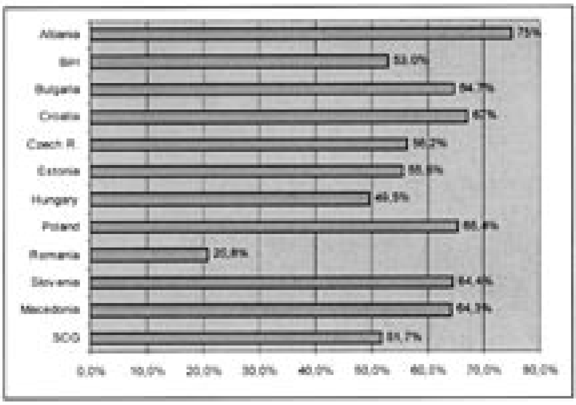
The data on the contribution of the SME sector to total GDP in other countries (e.g. in Albania, Hungary and Slovenia) show that this sector has strong potential, which should be exploited as much as possible. Therefore, it is necessary to create the best possible conditions and environment in Serbia for the establishment of new SMEs and further development of existing ones.

The experiences of most countries in transition show that SMEs employ more than half the total active labor force (see Graph 7). In this respect, the situation in Serbia has also been improving. So, in 2003, it was recorded that SMEs employed over 54% of total labour force. If one bears in mind the expected problems Serbia will face relating to an increased number of unemployed due to the effects of transition, the solution to this problem can be seen in further SME sector development. Since it is expected that the unemployment rate will continue to increase until the end of the privatization process, it is necessary to encourage SMEs to employ redundant workers by implementing additional measures. So far, the only incentive policy consists in the exemption of those enterprises which employ new workers from paying corporate income tax (to the amount of 100% of gross pay).[4] Also, after adoption of the new

4. Article 49 of the Law on Corporate Income Tax, *Official Gazette of the RS,* No. 84/04.

Law on Personal Income Tax (beginning of 2005) all firms that employ a newly employed worker who previously has spent at least three months on the labour market are exempt from paying wage tax (during the period of one year).

Graph 7. Employment in the SME sector, 2002



Source: UNECE, 2003, *Small and medium size enterprises in countries in transition,* New York and Geneva and for Serbia Republic Development Bureau, The *Autumn Report*, October 2004, No 10

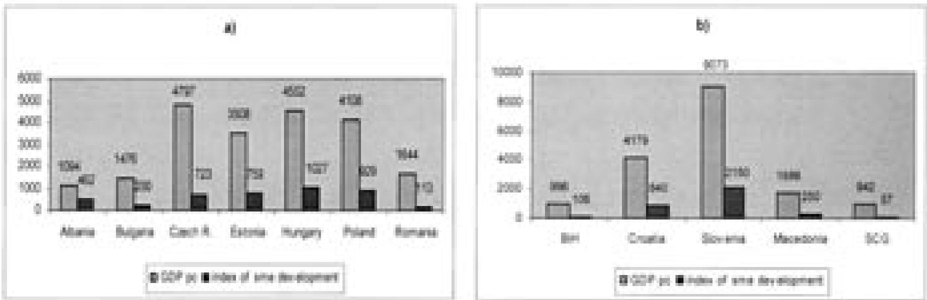
Finally, we enclose a summary review of SME sector development across the observed countries in transition by comparing their Index of SME Sector Development.[5] Since 1999, if considered by the value of the Index of SME Sector Development, two groups of countries have been singled out: 1) advanced countries in transition, in which the contribution of entrepreneurship to the achieved level of GDP per capita ranges from US$ 500 to US$ 1,350 and 2) less advanced countries in transition, where this contribution is only about US$ 100.

Graph 8 shows great disproportions in the value of the Index of SME Sector Development by countries. It is evident that, thanks to the best previous indicators (Graphs 5, 6 and 7), Slovenia has the highest Index of SME Sector Development. It is followed by Hungary, Poland and one more former Yugoslav republic - Croatia. If the situation in Serbia is compared with that in other former Yugoslav republics, it can be observed that Serbia is lagging behind them both with respect to the level of general economic development (measured by the level of GDP pc) and with respect to the level of SME sector development. There is no doubt that its poor performance cannot only be explained by the consequences of war devastation, sanctions and NATO

5. Introduced by UNECE in 1999.

bombing, since some other former Yugoslav republics also had a similar experience (Bosnia and Herzegovina and partly Croatia) and their level of SME sector development is almost twice as high (BiH), or almost fifteen times higher (Croatia) than that in Serbia (graph 8b). This disparity becomes even more evident when other countries in transition are also included in the analysis (graph 8a).

Graph 8. A comparative analysis of the Index of SME Sector Development, 2002 (in US $)



Source: UNECE, 2003, *Small and medium size enterprises in countries in transition,* New York and Geneva

Therefore, to improve economic performance in general, it is necessary to make an additional effort to create the environment that will be suited for SME sector development. There is no doubt that a four-year period of reforms is not long enough to create an adequate economic environment, but it is also the fact that the results hitherto are far below the expectations, potential and needs of the environment with which we must keep pace. It is necessary to remove the barriers encountered by the SME sector in its day-to-day operations at an accelerated pace. Thanks to the economic policy measures hitherto, some of these barriers have partly been alleviated,[6] while others still pose an insoluble problem. We will turn our attention below to the greatest

6. At the end of April 2003, the National Assembly of Serbia enacted the Law on Planning and Construction ("Official Gazette of the RS, No. 47/03) which, to a significant extent, simplifies the procedure for granting a building permit and enables its decentralization, since the cities and municipalities are now in charge of spatial planning and development, construction of projects and building land management. The amendments to the Law on Private Entrepreneurs were also adopted ("Official Gazette of the RS", No. 35/02), thus alleviating (or, in some cases, abolishing) the entrepreneurs' obligation to include the decisions of the competent inspection authorities in the registration procedure. Also, the provisions of the Law on the Registration of Business Entities (*Official Gazette of the RS*, No. 44/04) and the Law on the Agency for the Business Register (*Official Gazette of the RS*, No. 55/04) came into force on 31 December 2004. They stipulate the shortening

problem which is faced by the economic sector in the opinion of most SME sector representatives - the lack of financial resources - as well as to the solutions which are available to the economic policy makers in Serbia.

3. Financial Support of SME Sector Development

3.1 Sources of Finance of SMEs' Needs in the SEE Region

Access to finance is essential for private sector development and especially for the SME sector. However, numerous studies show that just the access to finance represents one of the main barriers to SME development across the SEE region.[7]

Because of the poor level of development of the financial sector in SEE as compared to western economies, and because of the relatively higher risk aversion of banks in SEE, the severity of financial constraint is much stronger in this region than it is in advanced market economies. Moreover, according to the BEEPS, finance is ranked as the most severe obstacle in Bosnia and Herzegovina, Bulgaria, Croatia and Serbia and Montenegro, whereas it ranks last only in Albania and second in all other countries.

Table 2. Perception of severity of lack of finance, data on availability of finance and sources tapped by SMEs

Country	Ranking of finance among all obstacles	Rating access to finance*	Share of internal funds in total finance accesses		Share of bank loans in total finance accessed	
			Working capital	New investments	Working capital	New investments
Albania	5	2.5	89.1	87.5	3.4	4
Bosnia and Herzegovina	1	2.6	74.2	73.5	13.2	16
Bulgaria	1	2.9	75.4	78.9	9.5	9.6
Croatia	1	2.5	59.1	52.4	14.5	21.2
FYR Macedonia	2	2.4	66.9	63.9	12.4	11.2
Moldova	2	2.8	76.5	76.8	12.4	11.2
Romania	2	2.7	75.5	78.4	11.3	10.5
Serbia and Montenegro	1	2.7	87.4	90.1	5.3	4.3

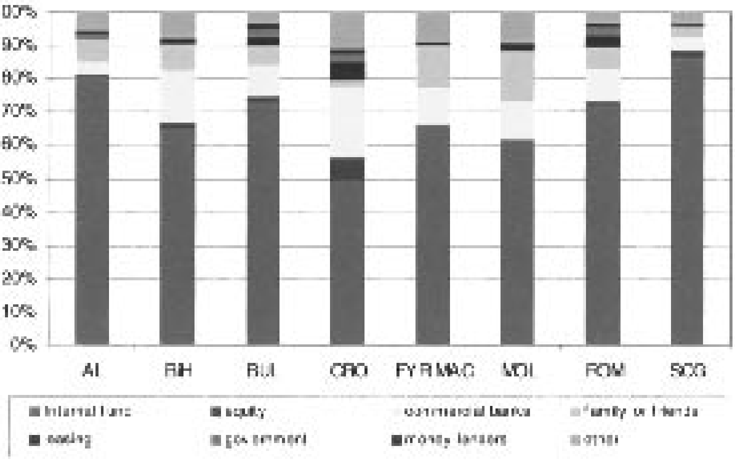
Source: OECD, Enterprise Policy Performance Assessment for SEE, 2003. Note: * the scores are interpreted as follows: 1=very poor, 2=poor, 3=satisfactory, 4=good, 5=very good

of the business registration procedure to 5 days and reduction in the amount of initial capital from € 5,000 to € 500. For the first time it is possible to have electronic access to the single base of registered businesses and private entrepreneurs. As of next year, it is planned to grant significant tax concessions with a view to encouraging employment. It is also expected that the reform of bankruptcy proceedings and the procedure relating to the enforcement of judicial decisions will begin. This should improve the current debt insurance and collection system to a great extent.

7. In this section the results of the following studies have been used: OECD, Enterprise Policy Performance Assessment for SEE, 2003 and EBRD-World Bank Survey: Business Environment and Enterprise Performance Survey (BEEPS), 2002.

In all SEE countries except in Croatia internal funds are by far the main source of financing for new investments, especially for SMEs. Reliance on internal funds for SMEs ranks from 50% in Croatia to 86% in Serbia and Montenegro. Borrowing from commercial banks covers a relatively small percentage of financial needs for new investments, although there are wide variations across the region. For instance, in Croatia banks provide about 46% of funds for new investments for large enterprises and 21% for SMEs. This contrasts with Albania where the corresponding figures are 10% and 4%.

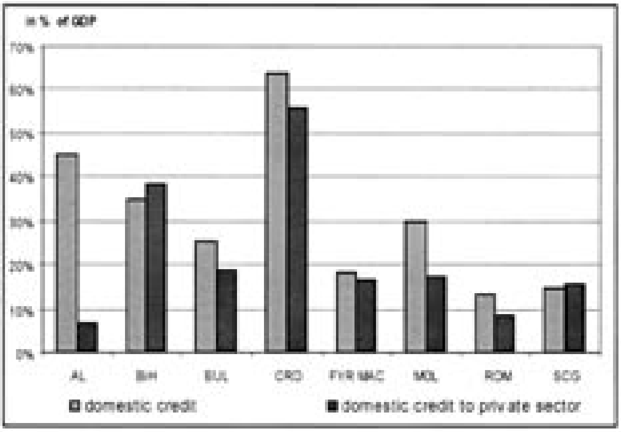
Graph 9. Sources of finance for small and medium size enterprises, 2002



Source: OECD, Enterprise Policy Performance Assessment for SEE, 2003

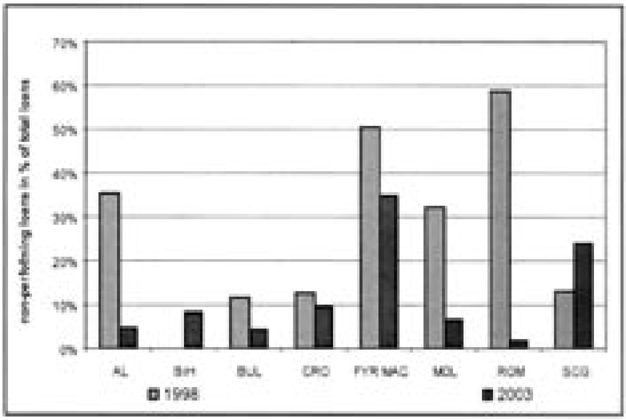
Despite the profound transformation undergone by the banking system of the SEE countries, the level of banking intermediation in these countries is still low (in 2002 domestic credit averaged about 30.6%of GDP in the SEE area, as compared to 135% in the EU; domestic credit to the private sector is even lower: at an average of 21.7% of GDP in the region, as compared with 113% in EU). Moreover, the average bank capital-to-GDP ratio at the end of 2002 was about 51% in SEE. Secondly, interest rate margins in these countries are still very high (10.8% on average) indicating a high degree of inefficiency, as well as continuing low competition in the banking sector in SEE.

Graph 10. Domestic credit in SEE, 2002



Source: OECD, Enterprise Policy Performance Assessment for SEE, 2003

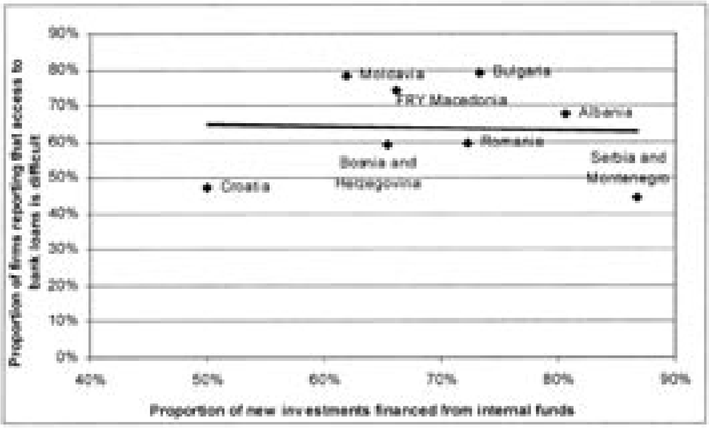
Graph 11. Quality of bank lending



Source: Transition report, 2004
Note: data for BiH in 1998 were not available

The BEEPs contains further insights into difficulties in the SEE banking sector, especially for SMEs. On average, 47,5% of SMEs in the region claim that it is either fairly difficult or impossible to obtain a bank loan for working capital, while 63,6% of them consider it difficult or impossible to obtain credit for investment needs. These difficulties are least marked in Croatia (34.3% and 47.4% respectively) while most marked in Bulgaria (75% and 70% respectively). Furthermore, the research shows that it takes 31 days on average across the region for banks to decide on a loan application. Reflecting the weak creditors' protection in much of the region, the average value of collateral required for granting a loan is 124% of the value of the loan.[8] SMEs typically compensate for the difficulty in obtaining finance from commercial banks by using internal funds.

Graph 12. SMEs bank finance vs. internal funds for new investments



Source: OECD, Enterprise Policy Performance Assessment for SEE, 2003

Alternatively, an enterprise can turn to external finance from stock markets, equity funds, family and friends, leasing facilities, the government, NGOs, donor programs and informal sources. Unfortunately, SMEs in the SEE region have insignificant access to most of these sources of finance. Stock markets in these countries are still under-developed. The ratio of stock market capitalization to GDP at the end of 2002 reached only 16% in Croatia and 10% in Bulgaria. Lease finance is available to a small extent in Bulgaria, Croatia and Romania (where the access to these arrangements is easier for large companies than for SMEs), while in other countries leasing plays an insignificant role as a financial source. Equity financing is a growing source but it still plays a minor role overall, especially for SMEs. These funds are mainly concentrated in Bulgaria and Romania, with only one SME-targeted equity fund which operates in Croatia. More significant types of financial sources include loans from family and friends, micro-credit institutions and SME credit lines. Loans from family and friends play an important role in financing micro and small busi-

8. Delays in developing land registries and functioning cadastres has precluded firms from using real estate as collateral in their efforts to access bank finance.

nesses, especially in countries that benefit from large remittance flows.[9] A number of international financial institutions and donors have helped in creating dedicated channels for financing micro, small and medium sized enterprises in SEE, such as micro-financed banks and SME credit lines through local banks. Micro-finance institutions are now in operation in all countries of the region. Data from the EBRD show that, on a cumulative basis up to the end of 2003, these banks had granted over 87,000 small loans to the value of 458 mil € with an average loan amounting to around 5,250 €.[10] Despite the fact that these loans are extended on a purely commercial basis, many entrepreneurs are happy to accept the terms and conditions of the loans, as the only alternative would be the extortionate rates charged by moneylenders.

3.2 Financial Support of SME sector Development in Serbia

The lack of financial resources poses one of the major obstacles to the further development of the SME sector in Serbia. The largest number of private enterprises (over 64.000) falls into the category of micro enterprises with only 3-4 employees and limited capital of about € 20,000. Since the system of financial support is not sufficiently developed, the largest number of SMEs relies on the founder-owner's capital, in addition to buyers' advance payments and suppliers' credits.

To a lesser extent, SMEs obtain necessary funds on the money market, where they trade in bonds and commercial paper with maturity of up to 12 months and up to 30 days respectively. Corporate bonds have all the characteristics of commercial paper and, as such, most often simulate security issue, which is basically a credit relation. Corporate bonds used to have a dominant share in total trade on the Belgrade Stock Exchange, but this year's trend changed the pattern of trade in favor of equity securities. But since the capital market in Serbia is still under-developed, enterprises must often obtain necessary funds through bank lending. However, due to their modest credit history, newly established enterprises are regarded as a risky category of debtors, so that banks insist on high security against risk. Since the law prescribes less strict control and audit for SMEs, information on their operations is not so easily accessible, while a special problem is posed by the lack of high-quality security. Therefore, external financing is still insufficient and unfavorable for the SME sector.

Although the lending activities of banks were intensified relative to the previous year, the lack of favorable financial support in the form of medium and long-term credits is still present. Available credits are predominately short-term ones (up to 12

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9. Data from the IMF Balance of Payments Yearbooks for 2001 show that, among all transition countries for which data are available, the top four are Bosnia and Herzegovina, Albania, Moldova and Serbia and Montenegro.

10. Source: EBRD, Spotlight on South-eastern Europe: An Overview of Private Sector Activity and Investment, 2004.

months), mortgage is excessive (200-300% of the value of security), while the interest rate is still not sufficiently incentive (0.5 – 2.8% per month). As a rule, credits are strictly earmarked and are granted with a grace period of up to 6-12 months. What is encouraging, however, is an upward trend in credit lines which are intended solely for the SME sector.

Table 3. Credit terms for SMEs in Serbia

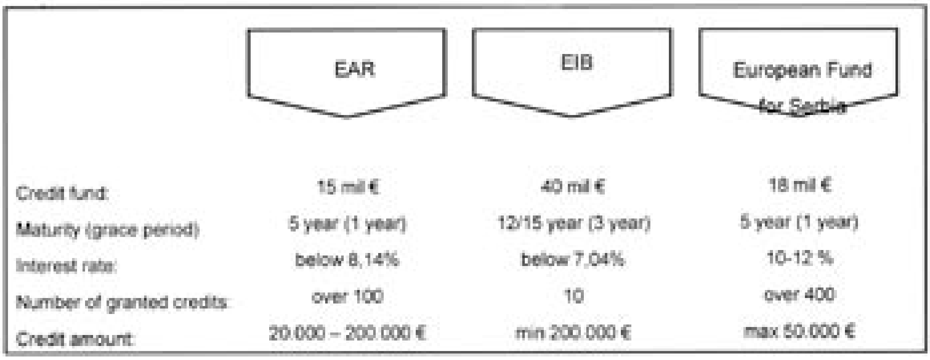
	CHARACTERISTICS
Purpose of credit	Credits for the SME sector are granted for financing: • Working assets; • Fixed assets and • Export. As a rule, priority is given to producing enterprises.
Amount of credit	The amount of credit depends on the shareholders' share in the bank's deposit potential, solvency of the enterprise and its business relations with the bank. As a rule, the minimum amount of credit is € 5,000. As for its upper limit, there are essential differences among banks. Some domestic banks have made credit line arrangements with the European Agency for Reconstruction (EAR), Reconstruction Finance Corporation (KfW), European Investment Bank (EIB) and other partners, thus increasing the amount of their loans to a considerable extent.
Interest rate	In setting the interest rate, several factors are taken into account: the purpose of credit, maturity, type of security, classification of credit beneficiaries, whether credits are granted in dinars or in foreign currency, etc. Therefore, the monthly interest rate ranges from 0.5% to 3%.
Security for credit	Credit is most often secured by: • Bill of exchange; • Bank guarantee; • Real estate mortgage in the 1:2 ratio; • Chattel (equipment) mortgage in the 1:3 ratio; • Security in the 1:3 ratio; • Foreign currency deposit; • Guarantee given by other two solvent legal entities.
Maturity	Credits are granted mostly on a short-term basis with the maturity of up to 1 year, but some banks also extend medium-term credits with the maturity of up to 5 years.

Source: National Bank of Serbia

As for the assistance of foreign institutions and funds, the European Bank for Reconstruction and Development (EBRD) has made the greatest contribution. The Bank is the largest private investor in South Eastern Europe and its activities are geared to the banking sector, through its support for the reconstruction and recapitalization of banks (Eksimbanka a.d. and Prva preduzetnička banka a.d.), as well as for the provision of bank guarantees and credit lines. To support the SME sector, the Bank granted over US$ 6 million in loans for its financing and over US$ 2 million for the purchase of one-third of shares of the Micro Finance Bank (now operating under the name ProCredit Bank), which specializes in the SME sector and offers a wide range of financial services.

In July 2002, the European Investment Bank approved the amount of € 20 mil for financing SMEs in the industrial and service sectors, as well as for infrastructure projects. The maximum amount of each credit is € 200,000 and the repayment period is up to 15 years. Through the European Agency for Reconstruction, the European Union approved a donation for the medium-term financing of SMEs. There are also other international institutions and funds which provide support for SME sector development in Serbia, such as the organization Southeast Europe Enterprise Development (SEED), which acts as a negotiator or, in other words, links interested enterprises with investors and financiers; European Commission (EC), Central European Initiative, etc.

Graph 13. Credit lines financed from EU/EBRD in Serbia



Source: Power Point presentation of the Governor of National bank of Serbia, *Financing SMEs in Serbia,* October 2003 (www.mpriv.sr.gov.yu/ser/sme/konferencija.asp)

The SME sector is also financed through the Development Fund of the Republic of Serbia. The basic model for raising its funds is on a credit basis. The Fund's share in the financing of SME investments (except for regional development) cannot exceed 40% of estimated investment, including the annual interest rate of 5% (7% previously) with the use of the currency clause. Credit funds are calculated on the basis of a 5-year repayment period (previously 3 years) and deferred payment period of up to one year. Debt service obligations are calculated and discharged on a quarterly basis, whereby the investments made two years before the decision was taken to extend credit are recognized as the investor's own share. In the course of 2003, 75.4% of the Fund resources were allocated to the realization of the investment programs where priority was given to SMEs. Realization of these programs ensured employment for 14,603 workers.

In December 2003, the Guarantee Fund started to operate with a view to further promoting financial support to the SME sector. Although its initial capital is modest (about € 8.5 mil), it enables the government to offer to banks the guarantees on behalf of SMEs, which the latter cannot ensure (e.g. due to unregistered property, which cannot be used as collateral for commercial banks). So far, cooperation with 18 banks has been agreed and it is expected that the number of banks will increase in the future. Guarantees are given up to the amount of € 150,000; security for credit usually amounts to up to 50% of the project value, while the guarantee commission depends on the credit amount, credit period, level of security for credit, etc.

The adoption of new legal provisions, which would regulate and improve the system of securing and collecting debts, would have a favorable effect on the lessening of the risk of financing SMEs. However, there are numerous aggravating circumstances, such as: a) an unclear ownership structure, long duration of the concept of social/state ownership (broadly understood); b) outstanding problem of denationalization; c) disorderly state of land books and bureaucratic efforts to exclude land registers from the jurisdiction of courts and confer jurisdiction over them on administrative bodies; d) long-standing limitation of an individual's right of ownership and inadequate laws relating to ownership in general.

So far, the adoption of the Law on the Right of Security over Immovables Entered in the Court Register provided conditions for a higher level of legal security in borrower-creditor relations, as well as for the efficient performance of credit transactions in the country. But, to be able to implement this Law, it is necessary to establish the securities register, which is expected to be done in mid-2005 (the Law on the Agency for the Business Register, *Official Gazette of the RS*, No. 55/04).

Also, the adoption of the Law on Leasing (Official Gazette of the RS, No. 55/03) facilitated access to modern equipment and technology without incurring additional debts. In the coming period it is expected that the Law on Investment Funds will be adopted. It should regulate a number of general issues relating to the minimum amount of the initial capital fund, obligation to pursue the investment aims and investment policy, openness to the public, etc. In that way, it would be possible to set up various financial institutions specializing in SMEs. The most significant institutions would be SME investment companies and venture capital funds, along with the various types of credit and development companies.

4. Improvement of Financial Support to the SME Sector in Serbia

4.1 SME Investment Companies

As specialized financial institutions in private ownership, SME investment companies would use their own (private) capital and credits guaranteed by the Guarantee Fund to finance SMEs. By their business policy, investment companies would determine the criteria for the selection of SMEs in which they would invest a maximum share of individual investments in the company portfolio and the like. In conceiving concrete solutions concerning the relationship between the company and the Guarantee Fund, it will be necessary to recognize the specifics of investing in SMEs. Namely, due to significantly delayed effects of investing in SMEs (at times, some investment may generate the effects even after several years of operations), one should not insist on the regular fulfillment of a debt service obligation to the Guarantee Fund. A good solution could be a specific credit instrument in the form of an equity security. By using such a security, the investment company would be enabled not to service its debt to the Fund until it earns a sufficiently high return on its investment, so that it can first pay dividends to its investors - shareholders. At the same time, the government could acquire an ownership share in the investment company through the Fund. Such a solution is much more compatible with the aims of financial support to SMEs and the specifics of these enterprises, than the classical model of financing on a credit basis. This solution would also ensure the long-term financing of SMEs.

Investment companies can be the sources of credit and constant, own capital in SMEs. To be compensated for a higher investment risk, investment companies could have the option to convert their outstanding debts to an ownership share in the enterprise they finance. However, it would not contribute to the development of entrepreneurship in the Serbian economy if investment companies obtain a controlling interest in the enterprises they finance. Therefore, it is necessary to limit the ownership share of investment companies in the capital of these enterprises.

A prerequisite for the establishment of these institutions is the adoption of the Law on Investment Funds, of which the Draft has been prepared. The Law should regulate a number of general issues of importance in the formation and functioning of investment companies, such as, for example, the minimum amount of the initial capital fund, the obligation to publish the investment aims and investment policy, openness to the public, bodies of the organization affiliated to the company, etc. However, what is more important for the implementation of this Law is the development of the financial market (through which investment companies operate), protection of the creditors' rights, judicial reform (especially of the commercial judiciary) or, in a word, the implementation of all necessary measures for reducing the general risk of investing in the economy.

4.2 Venture Capital Funds

Venture capital funds invest primarily in propulsive activities, that is, competitive industries, which are expected to have a high rate of growth during the next few years. As for the domestic economy, it is important to note that these funds do not have to invest only in "high technologies", which is illustrated by the case of Hungary, in which venture capital funds invest primarily in the processing of agricultural products, electronics, telecommunications, precision instruments, financial and information services and franchising networks. Venture capitalists invest in the activities that lie in the centre of the classical S curve of industry, i.e. neither in the early phase, when the technology and market are uncertain, nor in the late phase, when competition consolidates itself and the rate of sales increase begins to decline.

Venture capital funds, which would be established in Serbia, could take different legal forms and involve different forms of ownership. The experiences of other countries in transition show that these funds can be established by the government, banks, corporations, and domestic and foreign legal entities and persons, and that they can be organized as a joint-stock company, limited liability company or limited partnership. Regardless of the selected organizational or ownership form, the venture capitalist enables the entrepreneur to obtain the requisite capital, but his role does not end here. By taking an active part in the identification and evaluation of business opportunities or, in other words, in the selection of growth strategy, while at the same time providing managerial and technical assistance, assisting in the raising of additional capital and exerting influence on the selection of suppliers, buyers and other enterprise stakeholders, the venture capitalist helps the entrepreneur to achieve the common business aims.

The basic problem relating to the concept of venture capital in Serbia would arise in the last phase of the process, when one should be reaping the benefit of investing in propulsive entrepreneurial firms and, thus, achieve the aims of all participants in the process. The insufficient development level of the long-dated securities market, primary issue, as well as financial market instruments and institutions poses the major problem in closing the circulatory flow of venture capital. As the last phase in the circulatory flow, the »opening« of enterprises to the capital market is a prerequisite for sufficiently high returns that will justify the investment risk and efforts of the venture capitalist and investment banker. In that sense, this last phase is a prerequisite for the beginning of the overall process. The problem is alleviated by the fact that, in contrast to other investment funds, these funds do not have to invest only in securities, but may also invest in entrepreneurial projects, so that their share in the capital of an enterprise can also be expressed in stakes, and not in shares. In this way, the problem arising from an under-developed capital market is only delayed. Nevertheless, bearing in mind a relatively long time period for reaping the benefit of capital invested, the process of raising and allocating venture capital in Serbia could already be initiated should the participants in this process be convinced that all conditions will be created for deriving a benefit from investing in an entrepreneurial project.

As the investors directly linked to entrepreneurial firms, venture capital funds can contribute to a significant extent to the solving of the two acute problems faced by the Serbian economy - inefficiency of enterprise management and the lack of capital for restructuring and investment. By encouraging promising enterprises, venture capital funds can make a significant contribution to the further intensification of economic activity. However, the creation of conditions for the establishment and functioning of venture capital funds cannot be separated from the creation of conditions for the establishment and functioning of other investment funds. Therefore, it is necessary to carefully and systematically create an environment for the establishment and functioning of investment funds as soon as possible. The initial step should be the adoption of the Law on Investment Funds. But, although the problems of setting up investment funds are interrelated, the functioning of venture capital funds anticipates the least number of conditions. Bearing in mind their significance for SME sector development (and the overall economy), these funds could be given priority in the process of introducing investment funds into the domestic financial market.

4.3 Local Development Companies and Credit Companies in the Service of Financing SMEs

Local development companies are private corporations usually established by citizens, using their own funds, with the primary objective of supporting the financing of SME development in their community and, thus, contributing to its economic development. On the basis of the funds invested in SMEs in Serbia, local development companies could be granted credits by the Development Fund in full, or partly by the Fund and partly by commercial banks, insurance companies, pension funds and other financial institutions, whereby the other portion of this credit would be guaranteed by the Guarantee Fund.

Credits obtained from the local development company could be used by SMEs for the purchase of land, construction of a plant, acquisition of machinery and equipment, as well as for the provision of other forms of assistance. In the later development stage of institutional support to SMEs in Serbia, it would be possible to set up SME credit companies as credit institutions specializing in SMEs. The companies would be formed by using privately owned funds, with the guarantee given by the Guarantee Fund, and would extend medium and long-term credits to the SME sector.

5. Conclusion

The SME sector is considered to be one of the principal driving forces in economic development. SMEs spur the development of the private sector and entrepreneurial skill, display flexibility and adjustability to market trends and demands, create new jobs, ensure a diversified economic structure, contribute to an increase in exports and trade and, in a word, take an active part in the promotion of a market economy. In this respect, the expectations from the SME sector in Serbia are extremely high. However, to achieve the desired results, it is necessary to remove the obstacles encountered by SMEs in their day-to-day business operations.

One of the major obstacles to further development of SMEs in Serbia (and most other SEE countries) is the scarcity of funds. The largest number of private enterprises falls into the category of micro-enterprises, which are financed by using the founder-owner's capital, in addition to buyers' advance payments and suppliers' credits. Since the domestic capital market is still under-developed, and with credit terms of bank lending still being unfavorable, the most common use of finance is own or family capital.

In order to stimulate further SME sector development in Serbia, it is necessary to adopt the laws and regulations that will enable the establishment of various types of new financial institutions specializing in SMEs. The most important financial institutions whose establishment and/or presence should be encouraged are: investment companies, venture capital funds, and local development and credit companies.

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