

State Aid - deliberate investment or hidden corruption?

Belgrade

Transparency Serbia

Report from the data collected and processed by February 20, 2015.

1. Summary and Recommendations

1.1 Summary

The issue of state aid to enterprises is important because of its economic effects (whether the purpose of granting aid was achieved or whether there was distortion of competition), because every situation where state aid is granted creates the risk of corruption, and because of the obligations undertaken by Serbia on the basis of European integration.

The Law on State Aid Control from 2010, adopted to comply with EU regulations, focuses on **the control of distortion of competition** through state aid grants. In addition, some forms of state aid were left outside the scope of that Law. Other aspects of state aid control (legality and appropriateness) are subject to other regulations (the Law on Budget System, the Law on State Audit Institution, etc.).

In the context of this study, **Transparency Serbia** analyzed the compliance with regulatory **standards on notification and approval of state aid**, practical functioning of the **Commission for state aid control** and whether state authorities were verifying **the appropriateness of state aid**.

We concluded that **there was no adequate mechanism** the Commission could use to establish an intent to award state aid. This key fact means that the Commission **depends entirely on the will of the authorities** who granted aid to complete the application, or on the willingness of third

parties to inform the Commission through the application on the intent to grant aid, or on the already granted aid.

Similarly, hands of the Commission are also **"tied"** in situations where state authority **does not want to provide information** on cases when state aid was awarded and which the Commission can subsequently take into consideration.

This is one of the biggest problems in the system of state aid - **there is no adequate mechanism of control, responsibility and punishment** for granting state aid outside the law or for the complete disregard for the Commission. Thus, the question of the respect of legal obligations in practice largely comes down to goodwill of authorities to report all relevant facts to the Commission.

The impression is that **the Commission as a control state body is in unenviable situation**, due to the lack of adequate sanctions for a body that do not submit information. On one hand, strictly insisting on the application of the Law and making decision on the basis of available information would result in declaring state aid as illicit and enterprises would have an obligation to return received funds. On the other hand, as enterprises are protected by contract, they would have a full right to sue the state and certainly win the case in court. In this way, the purpose of the Law (Protection of Competition) would not be fulfilled, and the state would suffer double damage. The Law on State Aid Control does not stipulate responsibility of executives and employees in state bodies for violations of the Law when making a decision on the allocation of state aid, but that does not preclude the application of other regulations (Criminal Code, the Law on Budget System, etc.).

There also seems to be a kind of **tacit pact among state bodies** in cases when the funds have already been (illegally) allocated – state bodies fail to submit information, and the Commission fails to issue a decision on "the basis of available information." This is evidenced by the fact that **during the five years the Commission's work not a single decision on the return of illegal state aid has been issued.**

According to the provisions of the Law, **the Commission is a legal hybrid - a body with unnamed legal status that has the characteristics of an independent state authority, a special administrative organization and a working body of the Government.** Members have been appointed by the government, the procedure for dismissal has been regulated and it should guarantee independence and prevent arbitrary dismissal, but the body itself is not autonomous or independent. The European Commission reports on the progress of Serbia pointed out to the need for greater operational independence of the Commission, stating that this **should be manifested through ex post controls and the implementation of the provisions on the return of illegal state aid.**

It is interesting to note that the European Commission specified the manner in which "operational independence" should be manifested after the Government of Serbia addressed the objection of the EC on the operational independence of the Commission and responded in the Action Plan for 2013 that "the Commission has its own seal, letterhead and internet presentation".

In its work, the Commission adopted **a number of decisions, which, according to the estimate of Transparency Serbia, can be marked as disputable. The Commission also avoided to consider some cases of state aid allocation** (i.e. the cases that had all the characteristics of state aid).

Some of these cases are described in detail in this report, such as, for example, the allocation of state aid to the company PKC. In fact, the Commission implemented "creative math" after establishing that the state aid that the Government of Serbia allocated to the company PKC to open a factory in Smederevo was permissible and in accordance with the law.

There were also cases when the Commission **suddenly changed practice** - after approving state aid for subsidizing tractors sales and even exports for years, the Commission suddenly concluded that it was not responsible for this type of aid because tractor vehicles are intended for agricultural works and they fall under the category of subsidizing "agricultural products and fishery products" for which the Commission is not competent.

A special form of state aid are **state guarantees for loans of public enterprises**. Since the beginning of implementation of the Law on State Aid Control, in a dozen of cases the National Assembly adopted the laws on granting guarantees to commercial banks for the indebtedness of public enterprises under conditions that did not allow the possibility for these guarantees to be treated as state aid.

Especially important is the fact that in most cases these loans were not paid off by public companies, the guarantees were activated, and the debts of public enterprises turned into public debt. None of these guarantees were examined by the Commission for state aid control. The loans of Steelworks Smederevo reflect the same situation. All loans became public debt, Serbia is paying them off, and none of them were treated as state aid.

A waiver of revenues from airport taxes at Belgrade Airport in 2014 and 2015 in favor of the company Air Serbia was also not treated as state aid. The contract between the Government of Serbia, Jat Airways and Etihad (which was examined by the Commission and approved for the government state aid) stipulated a waiver of revenues. However, revenues should not be waived for the Government, but the Airport. As a shareholder, the Government of Serbia can only recommend the adoption of an agreement on debt relief, but cannot provide state aid. State aid is provided by the Airport and that state aid (\$17 million for the 9 months of 2014) was neither reported nor examined by the Commission.

Subsidies to foreign investors **for creating new jobs** also continued in 2014. In most cases, the Commission examined the agreements on these subsidies in the proceedings of subsequent control and issued a decision on authorized state aid. In most cases, the regulations were met. The Commission did not interfere in the relations on domestic market, (nor was that its mandate), although its decisions occasionally included brave (but unsubstantiated) statements like the one that "production of cable systems presents a specific product with good potential and placement in the market, which makes it is an important part of the economic structure and stability in the overall economic development of the Republic of Serbia."

The analysis of state aid in this segment reveals the impression that the system of state aid control is largely set up to meet the standards of EU and to fulfill obligations concerning the protection of EU market, while the protection of domestic market remained in the background. Therefore, **it is necessary to consider significant changes in this area and more closely connect the system of state aid control and the system for the protection of competition.**

One of the key issues in the system of state aid should be the question of its appropriateness. Does the amount of 700 million euros allocated annually achieve its goal - does it (permanently) increase employment, reduce regional disparities, and are the goals listed in the allocation decisions and in the decisions of the Commission, used for granting state aid, indeed achieved?

Serbia has no mechanism to determine this, and the analysis that we conducted for this study indicated that the **money was often spent inappropriately, and that there was no intention to achieve set goals.** Even in rare cases where indicators were defined, the effect was not completely determined, and the provision of state aid continued.

On step towards determining the effects or, at least, compliance with the conditions for allocation, is reflected in the regulation that precisely established criteria for granting subsidies for attracting direct investment. This regulation sets a limited time frame during which the fulfillment of certain conditions is monitored (for example number of employees). However, long-term effect is not measured.

In late 2013, a significant normative progress in this area seemed to be approached. The Action Plan for meeting recommendations of the annual report on Serbia's progress in European integration for 2013 planned adoption of a regulation that would serve to analyze the impact of state aid and decide whether state aid was appropriate and justified.

In May 2014, the Commission for state aid control notified Transparency Serbia that the regulation would be made, but that its drafting had been undertaken by the Ministry of Finance. According to available data (internet page of the Commission and Official Gazette of the Republic of Serbia), the regulation has not been made by the time this report was concluded.

In general, the survey clearly indicates **the need for significant changes in normative solutions for state aid control**, particularly in connection with reporting state aid control, **improvement of institutional solutions (status of the Commission), consistent practice of the Commission itself** and, especially, the need to **pay more attention to appropriateness of allocated state aid.**

1.2 Recommendations

For all these reasons Transparency Serbia points out the following key recommendations for further reforms:

- Clearly defining the legal status of the Commission for State Aid Control within the Public Administration Reform Strategy or reassigning its tasks to the Commission for Protection of Competition;
- Introducing a legal mechanism for the collection of data on regulations, operations and transactions that may constitute state aid, so that the controls would not depend on the good will of the donor. At the same time, databases should be used as much as possible;
- Controlling the appropriateness of state aid granted by the Commission, State Audit Institution, the body that allocates state aid and its supervisory body, along with setting precise indicators before allocating the aid;
- Stipulating the obligation of refund in case of inappropriate use or the ban on fund allocation to that body;
- Prescribing penalties for failure to report state aid, unlawful allocation and other offenses;
- Prescribing special rules for allocating state aid in the field of culture.