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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED

DEVELOPMENT POLICY LOAN

IN THE AMOUNT OF EUR 160.6 MILLION
(US$200 MILLION EQUIVALENT)

TO

THE REPUBLIC OF SERBIA

FOR THE

SECOND PUBLIC EXPENDITURE AND PUBLIC UTILITIES
DEVELOPMENT POLICY LOAN

February 16, 2018

Macroeconomics, Trade and Investment Global Practice
Transport and Digital Development Global Practice
Western Balkans Country Management Unit
Europe and Central Asia Region

REPUBLIC OF SERBIA - GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of January 31, 2018)

US$1.00	=RSD 95.32
US$1.00	=EUR 0.803
EUR 1.00	=RSD 118.7

ABBREVIATIONS AND ACRONYMS

BIU	Budget Inspection Unit
CAPEX	Capital Expenditure
CPF	Country Partnership Framework
CTA	Consolidated Treasury Account
DPL	Development Policy Loan
EBRD	European Bank Reconstruction and Development
EC	European Commission
EPS	Serbia's National Electric Power Utility (*Elektroprivreda Srbije*)
ERP	Economic Reform Program
EU	European Union
FDI	Foreign Direct Investment
FCP	Financial Consolidation Plan
FMC	Financial Management and Control
FMIS	Financial Management Information System
GDP	Gross Domestic Product
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
MoF	Ministry of Finance
NBS	National Bank of Serbia
NES	National Employment Service
NPL	Nonperforming loan
PDO	Program Development Objective
PEFA	Public Expenditure and Financial Accountability
PEPU DPL	Public Expenditure and Public Utilities Development Policy Loan
PERS	Public Enterprise Roads of Serbia (*Putevi Srbije)*
PFM	Public Financial Management
PforR	Program for Results
PIFC	Public Internal Financial Control
PSIA	Poverty and Social Impact Assessment
SAI	State Audit Institution
SBA	Stand-by Arrangement
SILC	Survey on Income and Living Conditions
SLA	Service-level Agreement
SOE	State-owned Enterprise
TA	Technical Assistance
VOZ	Passenger Rail (*Voz*)

Vice President:	Cyril E. Muller
Country Director:	Linda Van Gelder
Senior Practice Directors:	Carlos Felipe Jaramillo/Jose Luis Irigoyen
Practice Managers:	Gallina A. Vincelette/Juan Gaviria
Task Team Leaders:	Ekaterina Vostroknutova/Rakesh Tripathi

THE REPUBLIC OF SERBIA

SECOND PUBLIC EXPENDITURE AND PUBLIC UTILITIES DEVELOPMENT POLICY LOAN

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The Second Public Expenditure and Public Utilities Development Policy Loan (PEPU DPL2) was prepared by a World Bank team led by Ekaterina Vostroknutova (TTL) and Rakesh Tripathi (TTL) and comprising Fabiola Altimari, Aleksandar Crnomarković, Kornel Drazilov, Katharina Gassner, Elena Georgieva-Andronovska, Baher El-Hifnawi, Nikola Ille, Leah Laboy, Jelena Lukic, Raymond Muhula, Trang Van Nguyen, Lazar Šestović, Desanka Stanić, Srdjan Svirčev, Svetlana Vukanović and Hermina Vuković. The team benefited from guidance and support from Linda Van Gelder (Country Director), Stephen Ndegwa (Country Manager), Gallina Andronova Vincelette (Practice Manager), Juan Gaviria (Practice Manager), and Lada Strelkova (Operations Adviser). The team gratefully acknowledges the excellent collaboration of the Government of Serbia and the guidance of Miria Pigato (peer reviewer).

PROGRAM SUMMARY

THE REPUBLIC OF SERBIA
SECOND PUBLIC EXPENDITURE AND PUBLIC UTILITIES DEVELOPMENT POLICY LOAN

Borrower	The Republic of Serbia
Implementation Agency	Ministry of Finance
Financing Data	Amount: EUR 160.6 million. Terms: IBRD Variable Spread Loan; 20 years total repayment term, including 9 years of grace; level repayment of principal.
Operation Type	Programmatic (2nd of 2), single-tranche
Pillars of the Operation And Program Development Objective(s)	This is the second in a series of two development policy loans to support the Government of Serbia's multi-year fiscal consolidation agenda and transformation of energy and transport sector public enterprises and state-owned companies. The series supports critical policy and institutional reforms within three pillars with the following development objectives: (A) Improve public expenditure management through strengthened public financial management and public administration reform; (B) Improve the financial sustainability and efficiency of energy sector public enterprises; and (C) Improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies.
Result Indicators* (**See Section 4.1 for detailed description)*	A1 - Share of executed payments for public to public commercial transactions which were beforehand duly registered as commitments within deadlines prescribed by legislation: Baseline (end-2015): 60 percent; Target (end-2018): at least 90 percent A2 - The number of employees in the public sector, as determined by the Law on the Ceiling on Public Sector Employees, does not exceed the total of institutional-level limits set under the Law and its decisions: Baseline (end-2015): no; Target (end-2018): yes A3 - Increased share of positions within the education, health and social protection sectors mapped to new grades: Baseline (end-2015): zero; Target (end-2018): 75 percent B1 -Increased convergence of the guaranteed electricity supply tariff to reach market parity levels: Baseline (end-2014): 64 percent; Target (end-2018): 80 percent* B2 - Increased number of total beneficiaries of the Energy Vulnerable Program: Baseline (2014 annual): 60,600 households; of which 27 percent female headed households; Target (2018 annual): 70,000 households; of which 30 percent female headed households B3 - Increase in the share of the EPS workforce with education above secondary-level relative to 2015: Baseline (2015): zero; Target (2018): 5 percent B4 - Increase in Srbijagas' collection rate of current receivables: Baseline (2015): 80 percent; Target (average 2016-2018): 87 percent B5 - The approved Srbijagas 10-year development plan for the Gas Transport System Operator and 5-year development plan for the Distribution System Operator are in accordance with the adopted economic and financial appraisal methodology: Baseline (2016): No; Target (2018): Yes C1 - Level of annual direct budget operational support to the Railways Companies: Baseline (2015): RSD 13.5 billion; Target (2018): RSD 11 billion C2 - Improvements in labor productivity (measured by train kilometers per employee) and in asset utilization (measured by passengers per kilometer of track and ton per kilometer of track) relative to 2014: Baseline (2015): zero; Target (2018): 15 percent (for both indicators) C3 - Reduction in annual wage bill of railways companies relative to 2015: Baseline (2015): zero; Target (2018): 25 percent C4 - The government agrees with Roads of Serbia on performance levels for the different road classes with associated guaranteed funding levels committed: Baseline (for 2016 budget): no; Target (for 2019 budget): yes
Overall risk rating	Substantial
Climate and disaster risks	Are there short and long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)? Yes ☐ No ☑
Operation ID	P161184

IBRD PROGRAM DOCUMENT FOR A PROPOSED SECOND PUBLIC EXPENDITURE AND PUBLIC UTILITIES DEVELOPMENT POLICY LOAN TO THE REPUBLIC OF SERBIA

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed operation supports the multi-year fiscal consolidation agenda, reforms in public administration, and transformation of energy and transport sector public enterprises and state-owned companies of Government of Serbia (Government)**. The policy measures under the Public Expenditure and Public Utilities Development Policy Loan (PEPU DPL) – second in a programmatic series of two operations – are part of the Government's ambitious program of policy and institutional reforms and support the implementation of strategic sector objectives in the context of Serbia's European Union (EU) accession process. The DPL series has three development objectives: (A) Improve public expenditure management through strengthened public financial management and public administration reform; (B) Improve the financial sustainability and efficiency of energy sector public enterprises; and (C) Improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies. The DPL series is central to the World Bank Group Country Partnership Framework (CPF for FY2016–2020, report number 100464-YF) Focus Area 1: Economic governance and the role of the state, and is complementary to related operations and technical assistance (TA).

2. **The reforms supported by this DPL series are a crucial component of Serbia's growth and poverty reduction strategy.** Serbia's rapid growth before the global financial crisis was fueled by capital inflows and led to significant internal and external imbalances, with fiscal deficits averaging 5.3 percent of gross domestic product (GDP) in 2009-2014, and resulting in 2015 in a record high public debt, at 76 percent of GDP. Since then, Serbia has embarked on a fiscal consolidation and structural reform program, turning deficit into a surplus (0.2 percent of GDP in 2017) and reducing public debt. Although growth has reduced poverty, constrained by several recessions, the poverty rate declined only slightly, from 24.1 percent in 2014 to 23.5 percent in 2016, with most gains more recently.[1] Average consumption among the bottom 40 percent of the income distribution declined more than for the population average since the crisis, due to more severe losses in employment and labor income experienced by the poor. Although overall unemployment fell to 11.8 percent in 2017, informality is high and labor force participation low with 45.5 percent of the population inactive in June 2017. Achieving higher, more stable, and equitable economic growth would require building on the success of fiscal consolidation and addressing the long-overdue structural reforms that complete plan-to-market transition and resolve the deep-seated legacy and structural issues in the economy. These include: the oversized social and state-owned enterprises (SOEs) sector that distorts prices and crowds out private firms in factor and credit markets; significant fiscal support to inefficient SOEs that burdens fiscal accounts; and low public sector efficiency and quality of public service delivery. If they are not addressed, fiscal pressures stemming from these factors could compromise the gains already achieved by fiscal consolidation and structural reforms, and hurt growth and poverty reduction in the long-run.

[1] Poverty is measured as income below the standardized middle-income-country poverty line of US$5.5 per day in 2011 purchasing power parity terms (PPP). In addition, Serbia adopted the EU relative poverty measure as its official poverty rate starting in 2012. The latest *relative* poverty, that is the fraction of population living below 60 percent of the median income, was estimated at 25.5 percent and inequality at 38.6 Gini points, based on the 2016 EU Survey of Income and Living Conditions (SILC) for Serbia.

3. **The reforms supported by this DPL are at the forefront of the Government's fiscal consolidation and structural transformation agenda**.[2] In March 2014, a government with a strong majority was formed, giving Serbia a new opportunity to overcome past fragmentation and build momentum for reform. The Government is committed to focus on transforming the state administration, public finances, and the economy, along with a reinvigorated EU accession process. Its Fiscal Strategy for 2018-2020 continues with fiscal consolidation to ensure macroeconomic stability, improve financial sector stability and resilience, boost competitiveness, and ensure sustainable growth. Building on the positive fiscal performance in 2015-to-date, the public financial management (PFM) and public administration reforms need to continue to ensure fiscal sustainability through stopping accumulation of arrears, improving budget execution, and reforming the remuneration and grading system in public administration. Improving the financial sustainability and efficiency of energy and transport public enterprises and state-owned companies is critical to reduce direct and indirect government support to these sectors, which weighs heavily on the budget (for example, the current stock of guaranteed loans to the public enterprises covered by this operation amounts to 3.6 percent of GDP).

4. **This operation is expected to help Serbia carry out reforms advancing the transition from a planned to a market economy.** Successful implementation of reforms in the public administration, energy, and transport sectors will improve public service delivery and economic efficiency and create foundations for faster medium-term growth and private-sector-led job creation. With measures in place to mitigate substantial social impact from retrenchment and with a positive environmental impact, in the long-run these reforms will also help reinvigorate poverty reduction and improve equity. In particular, the reform of public administration supported by the DPL program has been key for the success of fiscal consolidation and introduced long-term equity and efficiency gains in the functioning of the public administration. Savings on subsidies to SOEs and on the wage bill, combined with revenue increases, have been the key drivers of the improvement in the fiscal situation (leading to a 0.2 percent of GDP fiscal surplus in 2017, compared to a deficit of 6.6 percent in 2014). In particular, between 2015 and 2017, the reforms aiming to increase efficiency and bring public energy utilities and railway companies on a more solid financial footing led to significant reductions in payment arrears, subsidies, debt, and contingent liabilities.[3] The stock of total guaranteed SOE debt fell from 7.1 percent of GDP in 2015 to 5 percent of GDP in 2017 overall (of which 3.6 percentage points are still contributed by the SOEs covered by this operation). Additional to these gains, long-term impacts from improved financial situation and sustained reductions in fiscal losses from SOEs are expected to be large, if the Government stays the course of its Fiscal Strategy.

5. **This operation has a substantial risk.** Risks to the operation include political, social and stakeholder risks related to sensitive measures such as labor optimization in public administration, electricity and railway companies, as well as electricity tariff increases for residential consumers. Substantial progress has been achieved in the implementation of key reforms to date, for example, in relation to fiscal consolidation and restructuring of electricity and railway companies, confirming their high priority for the Government, with the recovery in growth showing to the public the potential pay-offs to reform progress. Other mitigating factors are the high-level and implementation support to these reforms from related World Bank activities. As described in Section 4.2, these include Program for

[2] Annex 6 describes the changes to the policy matrix since DPL1.

[3] For example, subsidies to railway companies fell by 0.05 percent of GDP annually between 2015 and 2017, with their financial receipts fully covering expenditures, partly thanks to a 0.1 percent of GDP projected reduction in wage bill between 2013 and 2018. Improvements in the collection of revenues due to Srbijagas led to a decrease in accounts payable from EUR165m to EUR46m for the gas utility, with most of the improvement coming from SOEs in the industrial sector. Between 2015 and 2016, a reduction in guaranteed debt to Srbijagas by EUR214m is recorded. In the electricity sector, the collection rate from SOEs and other utilities increased to 97 percent in 2017 from 85 percent in 2016. As a result of improved financial standing, EPS has not taken any government loans in 2016 or 2017.

Results (PforR) operations in the public administration and transport sectors, TA in the energy sector, as well as reforms supported by the earlier state-owned enterprise DPL series. Other operations, including by the development partners, have been supporting public administration reform, and job creation and employment (see section 4.3). The ongoing EU accession process is also a fundamental anchor for the Government's reforms.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

6. **Growth in 2017 is estimated at 2 percent, a slow-down compared to 2016, but a solid performance compared to several years prior.** Since the global financial crisis of 2008, Serbia recorded three economic contractions and struggled to recover its pre-global-crisis growth pace. The economy contracted by 3.1 percent in 2009, by 1 percent in 2012 and by 1.8 in 2014. Although the first drop in activity was caused by the international financial crisis, the latter two were mainly due to severe floods and droughts. Just as growth picked up in 2016 to an estimated 2.8 percent, on the back of broad-based export and production growth, an extremely cold winter damaged crops and impeded hydroelectric production and construction, slowing growth to a mere projected 2 percent in 2017. The 2017 growth projections contain a downward revision of annual growth to 2 percent from previously projected 3 percent. Overall, investment remains low, and is projected to grow only 1 percent in 2017. In addition, with gradually recovering domestic demand, external accounts are estimated to have deteriorated slightly in 2017.

7. **Improved export performance has supported Serbia's recent growth, with the current account deficit falling from 11.5 percent of GDP in 2012 to 3.1 percent in 2016, a record low.** Since 2010, and in particular in 2013 when the carmaker FIAT started production in Serbia, exports have been a significant driver of growth. The fall in the merchandise trade deficit supported a narrowing of the current account deficit, with an improved service balance and net transfers helping as well. But as growth slowed in 2017 and despite continuing strong export performance, there has been a widening of external deficit to 4.6 percent of GDP. Increase in imports is mainly due to higher imports of electricity, other intermediate goods, and a recovered consumption. Foreign direct investment (FDI) more than covers the external deficit. In 2017, net FDI (in euro terms) increased by 13 percent through September compared to the same period in 2016, driven by small- to medium-size projects in diverse geographical locations.

8. **The recent recovery in economic activity has been reflected in improved labor market outcomes.** High unemployment is a longstanding issue in Serbia, although on a declining trend after reaching a peak of 24 percent in 2012. Results from 2017 were particularly encouraging, with the annual unemployment rate falling to 12.9 percent in September 2017. Despite a poor agricultural season and slowing growth generally, employment went up by 2.4 percent year-on-year (y/y). This was a combination of higher labor force participation rates and lower unemployment, although mainly driven by informal[4] sector job creation. Real wages trended up, with private wages catching up with public ones: wages increased 4.2 percent through October 2017, with public sector wages increasing by 3.3 percent y/y, while private wages rose by 4.7 percent y/y.

9. **The Government's fiscal consolidation program has contributed to a significant improvement in fiscal performance over the last three years.** The general government deficit was 1.3 percent of GDP in 2016, down from 6.6 percent in 2014. Under the program put in place in 2014, revenues increased, while at the same time expenditure was brought under control, with major savings from wage and pension reforms. Public sector wages and pensions were cut by 10 percent and a hiring freeze was implemented since 2014. The general government wage bill stood at 8.3 percent in 2016, and it is

[4] Defined as no social security contributions.

estimated to be at the same level in 2017. Fiscal consolidation continued in 2017 on the back of higher revenues. In 2017, lower capital expenditures (also affecting overall growth of the economy) helped bring fiscal account into a projected overall surplus of 0.2 percent of GDP.

10. **Resolving fiscal pressures from inefficiencies in the public sector remains at the top of the Government's agenda.** The remaining fiscal pressures that stem from the structural inefficiencies related to the unfinished transition from a planned to a market economy; more effort is needed to address these. Although recorded arrears have come down from 1 percent of GDP in 2009 to 0.1 percent of GDP in 2017, it is important to control their accumulation and improve recording. Publicly guaranteed SOE debt remains a major risk: enterprises covered by this operation (Srbijagas, Serbia's National Electric Power Utility [Elektroprivreda Srbije, EPS], railways, and Roads of Serbia) jointly hold a EUR 1.3 billion (3.6 percent of GDP) in guaranteed debt, accounting for three-quarters of all outstanding guarantees. Overall, there are more than 600 SOEs and more than 700 public enterprises (utility companies) most of which are loss making. With no reform, many of these enterprises might require financial support from the Government. In addition, there are large state-owned banks and insurance companies that pose financial/fiscal risks, should they require an intervention (see also para 14 below). Resolving these issues is an important part of the Government's priorities listed in its Fiscal Strategy and Economic Reform Program (ERP) discussed later in this program document.

11. **The general government debt has started to decline, also owing to the successful fiscal adjustment.** Public and publicly guaranteed debt continued to fall in 2017 after having reached the peak of 75.9 percent of GDP at end-2015. With financing requirements going down, the government debt decreased in 2016-2017 to reach 65 percent of GDP in October 2017. The total public debt went down by EUR546m in 2017, of which stock of guarantees went down by EUR321m. Reflecting commitment to tackle issues mentioned above, the fall in guarantees was due to a reduction in guaranteed debt to Srbijagas (by EUR265 million). Other debt reductions were due to repayment of debt that came due in 2017, US dollar weakening (about 30 percent of total public debt is denominated in US dollar), as well as the strengthening of dinar against the euro. Following an active debt management policy that included pay-offs and portfolio management actions, the cost of servicing the guaranteed debt went down in 2017 to projected 0.6 percent of GDP (from almost 1 percent of GDP in 2016).

12. **Monetary policy easing, along with recovery of consumption brought inflation back to the target band of the National Bank of Serbia (NBS).** Money supply, as measured by M1, was on average 14.5 percent higher through October (compared to the same period of 2016). Domestic demand increased by 2 percent over the first three quarters of 2017 (in real terms, compared to the same period in 2016) and inflation averaged 3.2 percent y/y over the first 11 months of 2017, compared to 1.1 percent over the same period in 2016. Consistent with its inflation targeting mechanism, NBS lowered its key policy rate twice in 2017 to reach 3.5 percent. The NBS continued to lower the key policy rate since core inflation remains low, at around 1.8 percent, y/y, while total CPI increased mainly due to one-off factors (increase in food prices and in prices of administratively controlled goods and services). The NBS's inflation targeting framework and commitment to maintain a flexible exchange rate appear appropriate, although high levels of euroization limit the monetary transmission mechanism.

13. **The Serbian dinar appreciated against the euro in 2017.** The recent current account improvement supported the exchange rate against the euro. As a result, the dinar appreciated by 3.3 percent through November. The NBS continues to intervene regularly to prevent more significant fluctuations in the exchange rate against the euro. By November 2017, the NBS was a net purchaser of foreign exchange (in total EUR 860 million), having raised gross reserves to nearly a third of GDP. The average real effective exchange rate appreciated by 5.5 percent through October 2017 (y/y).

14. **Overall, the financial system performance improved, although inadequacies remain in some state-owned banks.** Slow growth and repeated recessions were not without consequences for the

banking sector: nonperforming loans (NPLs) increased to the peak level of 23 percent as of Q3 2014 (from 11.3 percent at the end of 2008), and profitability of banks fell. The NBS undertook steps to mitigate the impact of the deteriorating quality of assets of the banking sector through the new Action Plan for NPLs resolution (approved in August 2015). As a result, the level of NPLs decreased to 11.9 percent by October 2017. However, there was no progress in the privatization of state-owned banks despite a growing pressure coming from the less-than-satisfactory performance of these banks. The NPLs in state-owned banks stood at 25 percent in mid-2017.

15. **After recovery in 2016, credit to corporations slowed down in 2017, reflecting a significant crowding-out from public sector borrowers.** Although the total loans were up 8.1 percent in 2016 (y/y), banks' lending to the government sector was up 25 percent and household loans were up 7.6 percent while those to enterprises (both private and public) were only 1.1 percent higher. In 2017, not only did the overall credit activity slow down, but loans to enterprises fell by 2.7 percent compared to a year earlier.

Table 1. Key Macroeconomic Indicators and Projections

	2014	2015	2016	2017e	2018p	2019p	2020p
Real Economy (in percent)							
Real GDP	-1.8	0.8	2.8	2.0	3.0	3.5	4.0
Contributions (in percentage points):							
Consumption	-1.1	0.1	1.1	1.8	2.4	2.6	3.7
Investment	-0.1	1.5	1.5	0.6	1.1	1.0	1.2
Net Exports	-0.6	-0.8	0.2	-0.4	-0.5	-0.2	-0.9
Exports	2.3	4.5	5.8	4.3	3.6	4.3	4.4
Imports	3.0	5.4	5.6	4.6	4.1	4.6	5.4
Unemployment rate (average, ILO def.)	19.2	17.7	15.3	13.1	13.0	12.5	11.5
GDP deflator	2.7	2.7	2.5	2.8	3.3	2.8	3.0
CPI (eop)	1.7	2.1	1.6	3.0	3.0	3.0	3.0
Fiscal Accounts (as percent of GDP)							
Expenditures	46.3	44.0	43.0	42.1	41.5	41.5	41.2
Revenues	39.7	40.4	41.7	42.4	40.9	41.0	40.7
General Government Balance	-6.6	-3.7	-1.3	0.2	-0.6	-0.5	-0.5
Public and Publicly Guaranteed Debt (eop)[a]	71.9	75.9	73.0	67.1	64.5	60.7	57.3
Selected Monetary Accounts							
Base Money (change)	10.9	17.1	20.5	..	..	..	
Credit to non-government (change)	6.1	2.0	2.5	..	..	..	
Interest (key policy interest rate)	8	4.5	4.0	..	..	..	
Balance of Payments (as percent of GDP)							
Current Account Balance	-6.0	-4.7	-3.1	-4.6	-4.2	-4.1	-3.9
Exports G&S	43.4	46.7	50.2	52.7	55.4	58.7	60.7
Imports G&S	54.3	56.4	56.6	60.3	61.9	65.0	66.9
FDI, net	3.7	5.4	5.5	5.7	5.2	5.3	5.2
Gross Reserves (in EUR bill, eop)	9.9	10.4	10.2	..	..	..	
In months of next year's imports	6.3	6.4	6.8	..	..	..	
In percent of short-term external debt	292	281	..	..	..	..	
Terms of Trade	0.8	1.5	..	..	..	..	
Exchange Rate (EUR, average)	117.3	120.7	123.1	..	..	..	
Other memo items							
GDP nominal in EUR billion	33.3	33.5	34.6	36.6	38.3	39.7	42.0
GDP growth (nominal, RSD)	0.8	3.5	4.0	4.9	6.4	6.4	7.1

Source: Ministry of Finance (MoF); World Bank estimates; International Monetary Fund (IMF); and NBS.
Notes: ILO = International Labour Organization; CPI = Consumer Price Index; eop;
a. World Bank projections; includes non-guaranteed debt of local governments.

2.2 MACROECONOMIC OUTLOOK, DEBT SUSTAINABILITY

16. **The economy is projected to grow at around 3.5 percent over the medium term.** In the medium-term, growth is expected to pick up, as both private and public consumption recover, to become the main driver of growth. Also, both public and private investment are projected to increase, from the current low levels (3.1 percent and 15.8 percent of GDP, respectively, in 2017). Both consumption and investment have a large import component which will result in increase in imports, thus the contribution of net-exports to growth will be marginally negative.

17. **In the medium term, external imbalances are expected to gradually narrow with the current account deficit set to decline to 3.9 percent of GDP by 2020.** Improvements in the goods trade deficit will continue, in part due to a strong recovery in the EU and because of recent foreign investments which broadened the exports base, while the services surplus will also rise gradually. FDI (net), supported by reform progress and advancements in the EU accession process, are projected to be over 5 percent of GDP and to exceed the current account deficit. Nevertheless, gross external financing requirements remain sizeable at around 16 percent of GDP over the projection period (Table 2), with debt disbursements accounting for approximately three-quarters of the overall external financing sources, highlighting potential vulnerability related to shifts in international financial conditions.

18. **Inflation is expected to remain within the NBS target band.** Monetary policy will continue to be implemented through an inflation targeting framework combined with a flexible exchange rate (with any intervention focusing on managing excess currency volatility). The inflation target for 2017 through end-2018 would be 3±1.5 percent, a lower mid-point by 1 percentage point due to improved macro fundamentals as well as softer inflation expectations of the corporate and financial sectors.

Table 2. Balance of payments financing requirements and sources

(In percent of GDP)	2015	2016	2017	2018	2019	2020
Gross external financing requirements	**13.1**	**11.3**	**15.6**	**14.9**	**14.1**	**16.7**
Current account deficit	4.7	3.1	4.6	4.2	4.1	3.9
Debt amortization	7.0	8.7	11.2	9.4	8.3	11.2
Change in gross reserves (increase=+)	1.4	-0.5	-0.3	1.3	1.6	1.5
Gross external financing sources	**13.1**	**11.3**	**15.6**	**14.9**	**14.1**	**16.7**
FDI and portfolio investments (net)	5.4	5.5	5.7	5.2	5.3	5.2
Official capital grants	0.0	0.0	0.0	0.0	0.0	0.0
Debt disbursements	6.6	7.8	10.1	8.6	7.6	9.5
Other net capital inflows	1.1	-2.0	-0.3	1.0	1.2	1.9

Source: IMF; NBS.

19. **Implementation of the Government's ambitious fiscal consolidation and structural reforms program will support further decline in debt.** The baseline assumes continuation of the structural reforms, as supported by this DPL series, and fiscal prudence. Over the medium term, further gradual decline in both revenues and expenditures is projected. Revenues are conservatively projected, thus some of the one-off (non-tax revenues) are not included in projections. Expenditures are projected to decrease by about 1 percentage point over the medium term, mainly due to further savings in current expenditures which is expected to offset a projected increase of capital expenditures (from 3.1 percent of GDP in 2017 to 3.8 percent in 2020). Fiscal savings will partly stem from the proposed program, as it reduces current spending and subsidy needs from the SOEs, as well as promotes reductions in arrears. Under this DPL, strengthening of the Srbijagas governance framework and the introduction of an economic and financial investment evaluation methodology is expected to lead to increased cost control and more efficient investment planning. In the case of the Railways, direct actions have been taken to clear arrears to EPS, as well as to reduce and rationalize commercial debt. The revenue-to-GDP ratio is set to decline gradually (from 42.4 percent of GDP in 2017 to 40.7 percent in 2020). As a result, under the baseline scenario,

public debt-to-GDP is projected to fall from 67 percent (projected for end 2017) to around 57 percent by 2020. The Government's gross fiscal financing needs will go down significantly, from around 15 percent of GDP this year to around 12 percent (average 2018-2020).

20. **The projected public debt path is highly sensitive to slippages in the fiscal consolidation plan, weaker-than-expected growth, or a negative real exchange rate shock**. In terms of the debt profile, only around 20 percent of Central Government debt is with variable interest rate, with 80 percent fixed.[5] Most public debt is external direct debt (61 percent of the total) as of end-October 2017. Foreign-currency share is high, with 41 percent in euro and 31 percent in US dollars versus 22 percent denominated in local currency. As a result, a sharp real depreciation would move the debt ratio up markedly (to 90 percent of GDP in 2018, see Figure 1). Both slippages in fiscal consolidation progress (resulting in higher deficit than projected under the baseline) and lower-than-anticipated growth could also lead to the debt ratio rising again. Debt service is high, with interest and amortization paid on guarantees at 3 percent of GDP in 2018.

Table 3. Consolidated General Government Fiscal Operations

	2015	2016	2017	2018	2019	2020
Revenue	**40.4**	**41.7**	**42.4**	**40.9**	**41.0**	**40.7**
Taxes	34.6	35.7	36.9	35.9	36.0	35.8
Personal income tax	3.6	3.6	3.7	3.6	3.6	3.6
Social security contributions	10.9	10.9	11.2	11.2	11.3	11.3
Corporate income tax	1.5	1.9	2.5	2.0	2.0	2.0
Value-added taxes	10.3	10.6	10.7	10.6	10.6	10.6
Excises	5.8	6.2	6.3	6.0	6.0	5.9
Taxes on international trade	0.8	0.9	0.9	0.9	0.9	0.9
Other taxes	1.6	1.6	1.6	1.6	1.6	1.5
Non-tax revenue	5.5	5.6	5.3	4.7	4.7	4.7
Capital revenue	0.1	0.2	0.0	0.0	0.0	0.0
Grants	0.2	0.2	0.2	0.3	0.2	0.2
Expenditure	**44.0**	**43.0**	**42.1**	**41.5**	**41.5**	**41.2**
Current expenditure	40.4	38.8	38.0	37.4	37.2	37.0
Wages and salaries	8.8	8.3	8.3	8.3	8.2	8.1
Goods and services	7.5	8.0	8.2	8.4	8.3	8.3
Interest	3.2	3.1	2.9	2.5	2.6	2.5
Subsidies	3.3	2.6	2.5	2.4	2.4	2.5
Transfers	17.6	16.8	16.2	15.7	15.7	15.7
Pensions	12.1	11.8	11.3	11.1	11.0	10.9
Other transfers	5.4	5.0	4.8	4.6	4.7	4.7
Capital expenditure	2.8	3.3	3.1	3.6	3.8	3.8
Net lending	0.1	0.1	0.3	0.1	0.1	0.1
Amortization of guarantees	0.7	0.9	0.6	0.5	0.4	0.3
Fiscal balance	**-3.7**	**-1.3**	**0.2**	**-0.6**	**-0.5**	**-0.5**

Source: World Bank staff calculations on the data provided by national authorities.

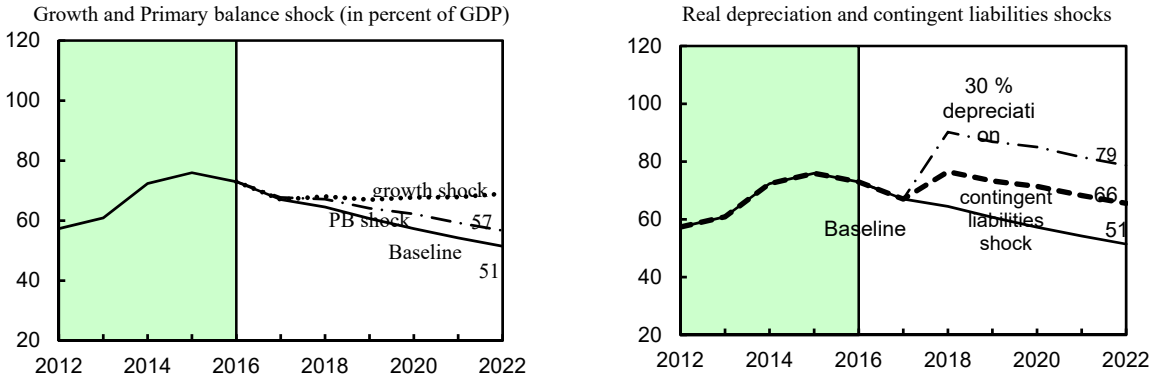
21. **The macroeconomic framework is considered adequate for the proposed operation.** Growth is projected to recover over the medium-term, with low inflation, and low fiscal deficits. These outcomes are underpinned by prudent macroeconomic management and the implementation of structural reforms,

[5] As of October 2017.

some of which are supported by the DPL series. The authorities are committed to continue with prudent fiscal policy to maintain debt sustainability over the medium term while supporting growth through structural reforms. Nevertheless, there are substantial downside risks to the macroeconomic framework, both external and internal. External risks relate to a lower-than-expected EU recovery that would affect Serbia through exports, remittances and capital flows. Climate-related volatility resulting in floods and droughts is also a significant downside risk, but one that is partially mitigated by a recently signed CAT DDO[6] with the World Bank and associated program, aiming to improve the disaster risk management nationwide. Higher volatility in international financial markets could also pose risks to the outlook through financial channels given Serbia's refinancing needs and foreign currency debt burden. Key domestic risks arise from the implementation of the fiscal reform program and management of state-owned banks. If some of these risks were to materialize the Government would need to undertake greater fiscal consolidation efforts to ensure that public debt remains sustainable.

Figure 1. Serbia: Public Debt Sustainability

Public debt-to-GDP, percent



Source: Serbia MoF, IMF, World Bank staff projections.

Note: Shaded areas represent actual data. Individual shocks (growth, primary balance) are permanent ½ standard deviation shocks from historical 10-year averages from 2016. One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2018, with real depreciation defined as nominal depreciation against US dollar minus domestic inflation (based on GDP deflator).

2.3 IMF RELATIONS

22. **The Executive Board of the IMF approved a three-year, SDR 935.4 million (about EUR1.2 billion, 200 percent of quota) Stand-By Arrangement (SBA) for Serbia on February 23, 2015, and on December 20, 2017, approved the eighth program review.** The program is based on three pillars: restoring the health of public finances; increasing the stability and resilience of the financial sector; and implementing comprehensive structural reforms to form a solid foundation for job creation and return to sustained high growth. The Government, the World Bank, and IMF have worked in close cooperation, for example, with the World Bank working collaboratively in providing upstream inputs on public administration reform and public enterprise restructuring and helping the Government develop a clear, time-bound restructuring plan for public enterprises and to complete functional reviews of certain line ministries. The recent eighth (final) review was concluded on December 20, 2017, completed the program which is expected to conclude on February 23, 2018 (see Annex 3). Arrangements for a future program are under discussion.

[6] Disaster Risk Management CAT DDO (Catastrophe Deferred Drawdown Option), see http://www.worldbank.org/en/news/press-release/2017/05/03/serbias-response-to-natural-disasters-improves-with-world-bank-help.

3. THE GOVERNMENT'S PROGRAM

23. **The Government's overall program is strategically oriented toward accelerating the EU integration process, maintaining macroeconomic stability, creating jobs, and boosting competitiveness.**[7] To accelerate EU accession, the Government is committed to speed up the implementation of economic reforms. The Government's priorities for fiscal consolidation and structural reforms are embodied in its Fiscal Strategy and its Economic Reform Program (ERP), presented to Parliament and to the European Commission (EC), respectively.[8] An ambitious economic program is set forth that includes continued fiscal consolidation to ensure macroeconomic stability; putting debt on a downward trajectory; improving financial sector stability and resilience; and structural reforms to boost competitiveness and ensure sustainable growth. Structural reforms include: (1) steps to strengthen the business environment by ensuring greater policy and institutional predictability, better coordination of different agencies, and more efficient incentive policies; reforming the labor market to make it more flexible; reforming and streamlining of the system for issuing construction permits; and upgrading of critical transport infrastructure; and (2) structural reforms of the public sector that aim to make it more efficient, reduce the footprint of the state, and lower fiscal risks.

24. **The PEPU DPL series is consistent with the Government' objective of making more effective use of public resources by improving delivery systems and strengthening PFM, support to increased efficiency and financial sustainability of SOEs and public enterprises, and reducing fiscal risks related to contingent liabilities.**[9] Under Pillar A, important milestones in public administration reform have been achieved including a hiring freeze, enactment of legislation establishing the registry of public employees and the ceiling on their number, to support monitoring and control of staffing, and freezing of wage indexation. These reforms have already contributed to the reduction in the level of spending on public sector wages relative to GDP. The new, systemic, "umbrella" Law on the Salary System of Public Sector Employees was also adopted in 2016 and amended in 2017.[10] Under Pillars B and C, pivotal reforms are taking Serbia further in the transition to a well-functioning market economy and helping fulfil commitments toward EU accession. A Government priority is the finalization of commercial SOE privatization and the corporatization of large energy utilities and transport companies so that they are run on a commercial, efficient, and financially sustainable basis, as supported by this DPL series. Since the 1990s, the transition to commercially-oriented utilities in Serbia's energy and transport sectors has lagged considerably behind other countries in the region due to systemic institutional inadequacies and strong vested interests. Energy and transport reforms aim to improve the efficiency of these public services and reform them in line with commitments toward the EU.

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[7] Serbia obtained the candidate status for membership in the EU on March 1, 2012 and in June 2013 the European Council endorsed the Commission's recommendation to open accession negotiations. The formal start of Serbia's accession negotiations was in January 2014 and the first chapters were opened in December 2015.

[8] The Fiscal Strategy serves as an overview of ongoing and planned structural reforms and as a tool for budget planning. The ERP's main purpose is to identify reforms for advancing the EU accession process. Both documents are updated annually. For the 2016–2018 ERP and Fiscal Strategy documents see http://www.mfin.gov.rs/UserFiles/File/dokumenti/2016/ERP-2016_en.pdf and http://www.mfin.gov.rs/UserFiles/File/dokumenti/2016/FS%20za%202016%20EN.pdf respectively.

[9] Reform of public finances is one of the five main objectives in the broader Public Administration Reform Strategy, and the focus of the PFM Reform Program which was adopted in late 2015.

[10] Amendments to the Law were adopted on December 14, 2017. http://www.parlament.gov.rs/upload/archive/files/cir/pdf/zakoni/2017/3776-17.pdf.

4. THE PROPOSED OPERATION

25. **The PEPU DPL series supports the Government's multi-year fiscal consolidation agenda under the following three development objectives:**

- Pillar A: Improve public expenditure management through strengthened public financial management and public administration reform.
- Pillar B: Improve the financial sustainability and efficiency of energy sector public enterprises.
- Pillar C: Improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies.

26. **Policy actions support the implementation of strategic sector objectives in the context of Serbia's EU accession process.** As described in the previous section, the proposed operation is fully aligned with the Government program. Public energy and transport reforms are important vehicles to accelerate EU integration. The new Energy Law (2014) aligns the legislative framework with the EU's third energy package and paves the way for the integration with the EU internal energy market.[11] In transport, the 2008–2015 transport strategy for railway, road, inland waterway, air and intermodal transport, National Railway Infrastructure Program 2017-2021, the 2011 Law on Public Roads, the 2013 Railway Law, and the Railway safety interoperability Law set targets in line with the EU legal and regulatory frameworks. In 2016, Serbia opened negotiations with the EC on chapters 14 and 21 on transport policy and Trans-European networks, respectively. Other policy actions such as electricity pricing reform and railways financing policy are critical to advance the implementation of the EU framework for the creation of competitive railway and electricity markets. Similarly, measures in Pillar A support the Government's high priority objective of aligning the public administration with the principles of the European Administrative Space.

27. **The prior actions in DPL2 continue the ambitious reform program envisaged by the policy reform matrix in DPL1.** As detailed in Annex 6, all indicative triggers identified under DPL1, were converted to prior actions with mostly minimal changes. Changes to Prior Action 1 and the corresponding results indicator reflect better understanding of the priorities of PFM reform. Prior Action 3 was revised to reflect the more ambitious scope and more involved consultations process that has been required for the wage system reform. Results indicator B3 was changed to better reflect the Pillar B development objective of increased efficiency of energy public enterprises (in particular, EPS).

4.1 PRIOR ACTIONS, RESULTS, AND ANALYTICAL UNDERPINNINGS

PILLAR A: PUBLIC EXPENDITURE MANAGEMENT

Strengthened Public Financial Management

28. **Public Financial Management reform is one of the Government's key priorities, and it includes measures to resolve and eliminate new accumulation of arrears**.[12] Although there has been

[11] Specifically, it introduces full unbundling of the electricity and gas transport and distribution sectors, fully opens the market for competition, advances deregulation of energy prices, and enhances the independence of the national regulatory authority.

[12] The comprehensive PFM Reform Program for 2016–2020was adopted in late 2015 and informed by the 2015 Public Expenditure and Financial Accountability (PEFA) assessment, and an Organization for Economic Cooperation and Development/SIGMA assessment, and supported by the EU, World Bank, and several bilateral donors, including GIZ and the Swiss Agency for Development and Cooperation. Measure 8 and 16 of the PFM Reform Program include reform actions to improve management of commitments and arrears.

a reduction in the stock or recorded arrears, weaknesses in ex-ante commitment control and lack of discipline in timely ex-post recording of incurred commitments result in unreliable data on commitments and arrears. Level of unrecorded arrears is assessed to be high, but without proper recording they are not taken into account in the budgeting process, thus undermining budget process and its credibility. Given high levels of past arrears to utility companies, these challenges affect not only the aggregate fiscal performance, but also the efficiency and financial sustainability of large public enterprises and SOEs, including those in energy and transport.

29. **The DPL series supports fundamental measures aimed at improvements in recording and control of commitments and arrears, which eventually should lead to their complete elimination**. Measures have been taken to better manage arrears[13], such as adoption of the Law on Deadlines for Payments in Commercial Transactions (RINO Law) [14] and putting in place RINO system[15] for recording and monitoring arrears, as well as revisions to the Budget System Law. But the lack of discipline in registering commitments within prescribed deadlines, combined with insufficient capacity of the Budget Inspection to supervise compliance with legislation and impose sanctions, resulted in limited benefits from the system. The measures under this DPL are expected to help correct some of these deficiencies.

30. **Prior Action #1 under DPL2 is designed to enhance monitoring and management of arrears by strengthening Government's supervision capacity and improving budget discipline**. First, the legislation on the role of budget inspection sets forth a supervision mechanism aimed at improving discipline in recording commitments through oversight and punitive measures. Second, strengthening financial management and control (FMC) is one of the core elements of the Public Internal Financial Control (PIFC) strategy, and it will help ensure more orderly application of existing procedures and compliance with legislation. Third, the introduction of stricter requirements to register incurred commitments in the amended Rulebook is another step towards more complete and up-to-date information on arrears. As the work of budget inspection covers state-owned and public enterprises, which are also mandated by the law to implement the PIFC framework, this Prior Action both directly and indirectly helps improve their financial sustainability in the long-term.

Prior Action #1. The Borrower has:

(a) issued the Decree on Work and Role of Budget Inspection, to strengthen the budget inspection supervision and enforcement function;

(b) adopted the PIFC Strategy and its associated action plan, to provide a framework for planned future developments of financial management and control and internal audit functions; and

(c) through its Ministry of Finance, amended the Rulebook on the Budget Execution System, in order to ensure that accurate, complete and up-to-date information on budget commitments are available at the time when budget commitments are incurred.

31. **The Decree on the work and authorities of the Budget Inspection helps strengthen budget supervision and enforcement functions.** The Budget Inspection Unit (BIU) collects information on commitments and liabilities from the Financial Management Information System (FMIS) and RINO

www.mfin.gov.rs/UserFiles/File/dokumenti/2016/Public%20Financial%20Management%20Reform%20Program%202016-2010%20EN.PDF.

[13] See, MoF, PFM Reform Program 2016–2020, November 2015.

[14] The Law was adopted in 2013 and amended in 2015, with support from DPL1. It sets a maximum period for settlement of payment by a public sector entity to a private sector creditor, before interest could be charged. The "Rulebook" for the method and procedure for monitoring the implementation of the revised Law was published in the Official Gazette, October 23, 2015.

[15] Software for commitments control (RINO, standing for "Registry of Settlement of Pecuniary Commitments") which is linked to payments software and which aims to improve the availability of information about assumed commitments, meeting of statutory deadlines for payment and to prevent accumulation of potential arrears.

systems, while the legislation on Deadlines for Payments in Commercial transactions empowers BIU to impose sanctions based on the information from these systems. But BIU's capacity to perform these functions is limited. To improve BIU's ability to verify the reported outstanding liabilities and arrears, the Decree defines the role and authority of the Budget Inspection, elaborates on the function and manner of conduct of work during inspections of budget users, further serves as the basis for working methodology of the Budget Inspection. Given limited number of inspectors, this approach improves the sampling of inspections by allowing to trigger inspections based on complaints. The act also establishes a uniform standard and a manner of work between the BIU at the MoF, provincial, and local government budget inspections, which allows for discussion of work programs of the BIUs of lower level of governments with the MoF which should contribute to their increased capacity.

32. **The Public Internal Financial Control (PIFC) strategy provides a framework for planned future developments of financial management and control, and internal audit functions.** The PIFC is part of Serbia's EU Acquis Chapter 32 'Financial Controls' negotiations, together with external audit, protection of EU financial interests and protection of the euro against forgery. The framework comprises three elements: (i) Financial Management and Control (FMC), (ii) Internal Audit, and (iii) Central Harmonization Unit (CHU). The Budget System Law provides general provisions with regard to development and implementation of the PIFC framework, while the accompanying by-laws and the PIFC Strategy regulate this area further and encompass strategic guidance on the future path of PIFC implementation. Further implementation of the PIFC framework will ensure instituting adequate procedures within budget entities, as well as respective compliance with such procedures and legislative requirements through strengthened functions of financial management and control and internal audit, thus improving recording and management of arrears.

33. **Improvements to the Rulebook aim to ensure that accurate, complete and up-to-date information on commitments is available at the time when commitments are incurred** (instead of requiring that those are registered just before they are intended to be paid as it was the case earlier). The amendments align this act with the requirement of registering of all commitments three days after they had been incurred, registering the amounts and schedule of expected payments under contracts/commitments, procedure for changes to registered commitments and improve comprehensiveness of information about commitments. The amendments to the Rulebook on Budget Execution System are an important regulation for deriving reliable budget execution data, complemented by the ongoing efforts to put in place the central register of invoices. The rulebook makes requirements for registering commitments more stringent and enhances robustness of the framework for improved quality of data on commitments and arrears.

34. **Expected results:** The above set of actions is expected to support improved transparency and data on incurred commitments and the level of arrears. In particular, the share of executed payments for public-to-public commercial transactions (which was duly registered as commitments within deadlines prescribed by legislation) is expected to increase from the baseline of 60 percent at the end of 2015 to 90 percent at the end of 2018.[16]

[16] The reforms under DPL2 are intended to strengthen regulatory framework and supervision mechanisms, and at the same time create environment conducive to enhanced discipline among budget users through strengthening their capacity. They do not intend to bring about hard controls in the system however, and therefore full coverage is not expected by the end of this operation. Implementation of the central register of invoices, which is not explicitly supported by this operation, if successful, would introduce such and could potentially bring compliance to full.

Public Administration Reform

35. **Reforms in public administration support fiscal consolidation through a combination of ambitious reforms that aim to reduce the wage bill while at the same time enhancing performance of the public sector.** The general government wage bill grew significantly in the 2000s, rising from 8 percent to 10.7 percent of GDP between 2001 and 2008. Measures introduced by the Government to contain the wage bill –such as a hiring freeze and an overall cut in salaries– have helped to reduce it from 9.9 percent of GDP in 2014 to 8.3 percent in 2016 and 2017. However, these measures have not addressed the structural inefficiencies in the management of public administration that had –in the first place– resulted in inequity in the compensation and elevated wage bill. Key sections of public sector employment have not had the optimal number of employees thus undermining the efficiency of human resource management, and public sector management more generally. For example, although measures such as the general hiring freeze imposed in 2013 led to reduction in the wage bill, they did not specifically target positions in health, judiciary, and the police or education sectors which employ the majority of workers. A wage freeze, similarly, did not address the underlying problem in the structure of compensation: complex systems of pay and grading—with compensation rates above market levels in low skilled positions and below market levels for high level positions—which facilitated inequity, undermined employee morale and rendered the system vulnerable to ad hoc pressures from public sector unions.

36. **In this regard, the Government is focusing on three key activities – (a) revising the legislative and policy framework for public sector employment; (b) reforming the pay and grading system; and (c) rationalizing staffing levels in a structured manner.** These reforms are central to the Public Administration Reform (PAR) Strategy objectives of improving organizational and functional sub-systems of the public administration and introduction of a harmonized public service system relying on merits and improved HR management.[17] The implementation of this reform is supported by the World Bank's Program for Results on Modernization and Optimization of Public Administration and an EU Sector Budget Support.[18]

37. **To strengthen its system for controlling staffing numbers, the Government established a registry of public employees and enacted legislation to make it effective.** As part of the rightsizing and optimization program intended to improve the organization of the public sector, the assignment of competences among tiers of the Government, and the organization of work processes within various institutions, the Law on the Ceiling on Public Sector Employees (2016, DPL1 Prior Action #2) set employment ceilings for individual institutions resulting by end of 2017 in a net reduction of almost 28,500 employees (or approximately 5.7 percent of total) relative to the end-2014 baseline including through rationalization, retirement and other reasons.[19] Based on the budget available annually, and the functional reviews of staffing needs, subsequent annual Decisions under the Law will set the staffing limits for future years.

Prior Action #2. The Borrower has updated institution-level limits on employees in the public sector for calendar year 2017.

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[17] The work on the PA Reform strategy was supported in close cooperation by the World Bank, the EU, and several bilateral donors (Germany, UK, and Switzerland).

[18] The Program-for-Results (PforR) operation on Modernization and Optimization of Public Administration which aims to improve human resources management, financial management and procurement management in the public sector. See, World Bank. 2016. *Serbia - Program on Modernization and Optimization of Public Administration (Report No. 104182-YF).* Washington, D.C.: World Bank Group. The Program was declared effective on December 16, 2016.

[19] See also http://www.imf.org/External/NP/LOI/2017/SRB/120517.pdf, page 5.

38. **The Government is taking steps to resolve inequity, discretion and inefficiency in the pay and grading system.** In 2016 the "umbrella" Law on Public Sector Employees Salary System[20] introduced a new public pay structure aimed at reducing opportunities for *ad hoc* and arbitrary compensation arrangements for public administration employees, and at controlling wage costs (DPL1 Prior Action #3). Subsequently, the Government undertook a comprehensive evaluation of current jobs and pay grades, in consultation with all stakeholders including the trade unions. In July 2017, the Government adopted a catalog of jobs in the public sector. The catalog outlines the qualifications for all jobs and positions in public administration employment. In December 2017, the legislature approved the Law on Employees in Public Services—one of three subsidiary laws under the "umbrella law"—setting the principles of the grading system and the time table for implementation of the reform. Prior Action #3 supports the development and amendment of these key laws, which provide legal basis for transition to the new grades.

Prior Action #3. The Borrower has:
(a) amended the Law on Public Sector Employees Salary System;
(b) enacted the Law on Employees in Public Services; and
(c) enacted the Law on Salaries of Employees in Bodies of Local Sub-Government Units and Provincial Authorities,
all with the objective to provide the legal framework for the mapping of positions between the Public Sector Jobs Catalogue and the new pay grades set forth in the Law on Public Sector Employees Salary System.

39. **Serbia's history of 'stop and go' reforms requires a mixture of instruments that complement each other—to guarantee implementation.** This operation (DPL) is being closely coordinated with the World Bank's Program for Result (PforR) operation which focuses on reform actions towards improved management of public finances, namely human resource management, procurement and public financial management. The operation is also linked to the Sector Budget Support (SBS) operation supported by the European Union and the IMF's programmatic support to Serbia—all of which have significant coverage of reforms in public administration. While the DPL focuses on key policy and legislative actions required to support public sector reforms, the PforR helps them implement actual reforms by achieving mutually agreed reform targets. The DPL thus provides the strategic policy leverage to advance the implementation of difficult but necessary reforms across the public administration spectrum.

40. **Expected results:** The policy reforms are expected to contribute to the implementation of a new wage system in the public sector. It is expected that by the end of 2018, the number of employees in the public sector, as determined by the Law on the Ceiling on Public Sector Employees, does not exceed the total of institutional-level limits set under the Law and its decisions. In addition, the share of positions within the sectors with largest employment (education, health and social protection) mapped to new grades is expected to increase from zero percent in 2015 to 75 percent by the end of 2018.[21]

[20] The Law came into force on March 9, 2016. Official Gazette of the Republic of Serbia No. 18/2016.
[21] Increased share of positions within the education, health and social protection sectors contained in the Catalogue of Jobs in Public Services and Other Organizations in the Public Sector mapped to the new grades set out in the Law on Public Sector Employees Salary System.

PILLAR B: ENERGY PUBLIC ENTERPRISES

41. **Electricity and gas public enterprises are among the largest public enterprises in the country and a priority for the fiscal reform agenda and for the effort aimed at improving the efficiency of public enterprises.** Commercialization of electricity and gas public enterprises has lagged behind commitments made in the context of alignment of the sector with the EU Acquis Communautaire, despite the adoption of a legislative framework that enables competitive energy markets.[22] Two key factors that hold back the development of a competitive energy market in Serbia are the financial fragility of Srbijagas which holds the largest government debt of all SOEs (amounting to 5 percent of GDP in 2016), and the inefficiency of EPS which is the largest SOE in the country. Measures to improve the financial viability of Srbijagas are implemented because of the fiscal burden and contingent liabilities the entity represents in form of government payment of debt service obligations and due to potential future need of government support. Given that EPS financial position has been improving in recent years, with net income averaging at about EUR50m between 2015 and 2017, the focus is on increasing its efficiency to make it a competitive player in the integrated European energy market while containing costs.

Improving financial sustainability of Elektroprivreda Srbije (EPS)

42. **EPS faces a number of challenges to meet future demand and succeed in the competitive European power market.** The financial analysis carried out by the World Bank in 2015 projected that absent measures to improve operational efficiency and financial engineering, EPS would face liquidity issues in a matter of years. Key challenges for the company prior to the implementation of reform measures included: (a) operational inefficiencies, including, amongst others, overemployment; (b) below-cost tariffs for regulated consumers; (c) lack of payment discipline, particularly from public sector entities (collection rate of about 50 percent in 2014); and (e) obsolete infrastructure which needs to be replaced with a view to meeting EU safety and environmental standards.

43. **Numerous steps have been taken to resolve EPS' financial sustainability challenges, resulting in EPS good financial standing in 2015-2017.** Plans for corporate restructuring and financial consolidation for EPS were adopted in November 2014[23] and June 2015,[24] respectively. Corporate restructuring resulted in a more streamlined organizational structure and management.[25] The Financial Consolidation Plan (FCP) 2015–2019 sets out time-bound measures aimed at transforming the company into a commercially and financially viable utility. Specifically, the Government committed in the FCP for EPS to reach (a) increased revenues through the adoption of a tariff adjustment path aimed at reaching market parity levels compared to other countries in the region by 2019; (b) decreased operational expenditures and improved efficiency, including time-bound targets for labor rightsizing, improved bill collections, and reduced distribution losses; and (c) a transformation of the legal status of EPS from a public enterprise into a joint stock company so as to improve corporate governance. As a result of the measures taken, EPS has not required support from government in the recent past to meet its financial

[22] The 2014 Energy Law and the adopted secondary legislation pertaining to the law ensure a compliant legal framework for the implementation of the EU's Third Energy Package.
[23] Program for Reorganization of EPS. Government Conclusion 05 No. 023-15149/2014.
[24] Plan for Financial Consolidation of Public Enterprise EPS.
[25] The new corporate structure became effective on July 1, 2015. All 7 subsidiaries for electricity generation were merged with EPS while a new company, called EPS Distribution, was formed by merging the 4 subsidiaries operating the distribution network. In 2016, EPS Supply was also merged with EPS. As a result, there are now only two companies: *EPS*, which covers the activities mining and power generation, supply, and retail activities; and *EPS Distribution*, which operates the distribution system.

obligations and the fiscal cost associated with the company has stabilized.[26] Government-backed actions taken by EPS included tariff increases and a net reduction in the workforce, and the improvement in receivables collection which increased overall to 94 percent and 98 percent in 2016 and 2017.[27]

44. **The DPL series supports measures deemed critical to the achievement of the targets set out in the EPS FCP.** The analysis of all factors that influence EPS viability is taken into account when deciding on the appropriate annual adjustment needed to regulated electricity tariff applied in the residential market. Among these factors are progress made in the implementation of FCP the measures aimed at raising efficiency (notably labor rightsizing and operational improvements such as improvements in bill collection and network loss reductions) as well as the dynamics of regional electricity prices. Increased convergence from 64 percent of regional wholesale parity levels in end-2014 to approximately 80 percent by end-2018 is the target conditional on the analysis of the financial position of the company and the adequacy of resources for needed investments. Regional wholesale prices have been determined as relevant benchmark in the case of Serbia because: (a) prices for consumers in the free market (mostly industry) are aligned with regional wholesale market prices (adjusted for import costs); and (b) convergence to regional market prices will support the phasing out of price regulation for households, in line with the country's commitments toward the EU.[28] On the basis of the financial position of the company and the forward-looking capital investment (CAPEX) plan of the company, a nominal increase of the regulated supply tariff of 4.5 percent in 2015[29] and 3.8 percent in 2016 was implemented (supported by DPL1).

45. **DPL2 supports further annual adjustments to regulated supply tariffs while maintaining the protection of the vulnerable households.** Following the updated analysis of EPS financial situation, a nominal 2 percent[30] tariff increase was implemented on October 1, 2017, after approval by the Regulatory Agency for the energy sector. Poverty and social impact analysis shows that this tariff increase under DPL2 is expected to have limited impact on poor and vulnerable households, as detailed in section 5.1 and in Annex 5. Similarly, switching to other fuels (such as coal or wood) by vulnerable households is assessed as unlikely given relative cost of fuels, prevailing housing conditions that are not conducive to such switch, and availability of social protection programs.

46. **To support energy affordability among vulnerable households, a targeted assistance program has been put in place in the context of aligning Serbia's energy legislative framework with the EU**. Continued protection of the vulnerable households is an integral part of the process of bringing tariffs closer to cost-recovery levels. Electricity accounts for the largest share (72 percent) of household's energy expenditures, while for the 20 percent of the population at the low end of the income spectrum more than 90 percent of energy expenditure goes to electricity.[31] Accordingly, 36 percent of households in the lowest quintile spend more than 10 percent of their budget on electricity.[32] To address affordability concerns, in addition to existing social assistance programs to support household income (notably the

[26] EPS has relied on government guarantees to finance part of its investment program, with stock of state-guaranteed loans amounting to 1.2 percent of GDP in November 2017. Although these guarantees have not been called, as the debt is being repaid on schedule by the company, they represent a contingent liability should EPS lose its good financial standing.

[27] Improved receivables collection rates from SOE and public entities of 85 percent in 2016 and 97 percent in 2017 are reported.

[28] Transmission and distribution fees are determined by the regulator according to a cost-based methodology.

[29] The tariff increase which households faced in August 2015 was heightened by another 7.5 percent in additional excise tax, resulting in a 12 percent total rise.

[30] This nominal increase is equivalent to a zero change in real terms.

[31] Based on 2013 Household Budget Survey (HBS).

[32] World Bank policy note 'How vulnerable are Serbian households to high energy expenditures', shared with Government October 2016 and discussed at a Working Group workshop October 27, 2016.

financial social assistance program FSA, and monthly child allowance), in 2014 the Government put in place an Energy Vulnerable Customer Program which provides a discount of electricity and gas bills linked, among others, to income and the number of household members. While designed with relatively good targeting, World Bank analysis has shown that the Energy Subsidy Program for energy vulnerable households was at its inception fairly limited in terms of its coverage and had low take up.

47. **In the years since its introduction, the Government made efforts to improve the assistance program for energy vulnerable households to ensure adequate protection in the face of scheduled tariff increases.** In 2015, the year in which a tariff increase of 12 percent was implemented in the regulated supply market, the Government put in place an inter-ministerial working group to address weaknesses in the structure and implementation of the energy vulnerable assistance program. To increase coverage, a new decree entered into force on January 1, 2016 (supported by DPL1) that significantly increased electricity consumption eligibility thresholds, allowing energy vulnerable households who have higher consumption (for example, due to electric heating) to still qualify for the protection scheme. Given the size of the tariff increase implemented in 2015, the introduction of mitigating measures for energy- and income-poor households was essential to secure political support for the socially negative side-effect of financial improvements in the sector.

48. **The Government shows strong commitment to sustaining the energy vulnerable assistance program.** The inter-ministerial working group continues to meet periodically to monitor the effective functioning of the assistance program. As a consequence of a legal challenge issued against the decree protecting energy vulnerable households, local self-governments became the only implementing agency for the benefit in 2016, making it more complicated for FSA (poverty-targeted social assistance) and child allowance (CA) beneficiaries to obtain the status of vulnerable customers. This change in implementation led to a sharp drop in the number of beneficiaries in early 2016 (from 58,000 households in December 2015 to 4,500 households in January 2016). In response, the Government assisted local self-governments in familiarizing themselves with the administration of the program and closely monitored the program. As a result of this effort and commitment, the beneficiary numbers recovered in the course of 2016 and rise steadily in 2017. More than 67,000 beneficiary households were registered on average in January-November 2017 (amounting to RSD 1 billion of benefit amount), compared to under 48,000 registered in the same period in 2016 (RSD 516 million). The current structure and arrangements of the program are maintained by the Government going forward, with a similar allocated budget in 2018 as in 2017 of RSD1.05 million. The good functioning of the protection program for energy vulnerable households is an integral part of the sector financial consolidation effort as tariff increases need to be undertaken in a socially responsible way to be sustainable.

Prior Action #4: The Borrower, through the Council of the Energy Agency, has approved an increase of the electricity tariff for guaranteed electricity supply in calendar year 2017 and continued to protect vulnerable households from such electricity tariff increase by increasing the number of beneficiaries of the Energy Vulnerable Customers Program in calendar year 2017 compared to calendar year 2016.

49. **Expected results** include increased convergence of the guaranteed electricity supply tariff to reach market parity levels from 64 percent at end-2014 to 80 percent at end-2018, conditional on the analysis of the financial position of the company and the adequacy of resources for needed investments.[33] Increased number of total beneficiaries of the Energy Vulnerable Program, from 60,600 households in 2014 (of which 27 percent female headed households) to 70,000 households in 2018 (of which 30 percent female headed households). The target program coverage is revised to 70,000 from 90,000 envisioned at

[33] In line with the tariff methodology for the public supplier, the convergence will be measured by the difference between the guaranteed supply price charged by EPS and the prevailing regional wholesale price set on the basis of neighboring power exchanges (Hungarian exchange HUPX).

the DPL1 stage, after the above-mentioned changes in program implementation.[34] Enrollment of FSA and CA beneficiaries faced additional administrative costs starting in 2016 when the implementing authorities moved from Centers for Social Work to local self-governments. However, the Government's continuous effort and commitment to effective functioning of the program. with oversight by the Ministry of Energy and the inter-ministerial working group, are expected to ensure program coverage to reach at least 70,000 households in 2018.

50. **Optimizing EPS labor force is important for improving the efficiency of the company by increasing overall workforce performance, while strengthening financial viability.** The total headcount of full-time employees was 32,140 by end-2014, salary costs had been increasing, and only 20 percent of the workforce had university degrees.[35] The EPS labor optimization plan 2016-2019 adopted in 2016 (DPL1 Prior Action #6) is in line with international good practice and national legislation and regulations. One of the overarching principles of the labor optimization plan is improving the qualification of the workforce. A reduction of 5,000 employees between 2015 and 2019 is envisaged and is being achieved through a combination of natural attrition and voluntary separation. For workers opting for voluntary separation, financial incentives, well above those specified in the legislation for SOEs, are provided according to eligibility criteria based on the worker's age and years of service, eligibility for retirement, and legally required physical ability to perform job responsibilities. The optimization plan is expected to improve the competitiveness of the workforce, in particular by raising the average level of education; it also helps to contain costs and preserve gains achieved by the improved operational efficiency of the company. Labor Optimization is meant to be implemented in parallel with technological improvements in EPS's operations to increasingly align them with commercial practices.

51. **Continuing progress achieved under DPL1, DPL2 supports the implementation of the 2016-2019 EPS labor optimization plan.** Implementation of the EPS labor optimization plan has proceeded as planned. In 2016, 2,005 employees left the company (including 1,517 voluntary separations and 488 by natural attrition), resulting in savings of RSD1.025bn (a reduction of 2 percent of the nominal wage bill).[36] Before implementation of the labor optimization plan, 5 percent of the EPS' workforce had only primary education, and 23.7 percent had higher than secondary education degrees. Among those who left the company in 2016, 12.3 percent had only primary education, and 15 percent had higher than secondary, implying an improvement in the ratio of educated versus uneducated workers: a 0.4 percentage point increase in the share of higher-educated personnel (equivalent to a 1.6 percent increase in the share of workers holding secondary education and above) is observed. After the adoption of the updated Labor Optimization Plan for 2017 on September 18, 2017, six categories of employees were eligible to apply for voluntary incentive severance packages, as agreed with the Trade Union. As a result, 1,428 employees

[34] Previously, FSA and CA recipients were automatically considered energy vulnerable customers. From January 2016 onward, all applications are channeled through the local self-governments. FSA and CA recipients are required to apply at the local self-governments with their energy bills, the point of sale/metering identification number, and the decision of the Centers for Social Work. While the local self-governments are not supposed to re-assess eligibility of FSA and CA recipients with additional verification of family composition, income, and asset status (only applicants who are not FSA or CA recipients require a full-fledged eligibility determination procedure), the extra and sometimes duplication of the verification process for FSA and CA recipients represented a new and significant administrative hurdle. Delays with putting in place the new implementation arrangements, the low number of access points, and the limited capacity in the local governments to administer the new benefit have been limiting the take-up.

[35] In recent years, EPS has added 4,400 employees to its payroll through mergers of subsidiaries with the parent company, including MB Kolubara, and absorbing employees from unprofitable and previously spun-off companies. These mergers increased staff costs from RSD 53.8 billion in 2013 to RSD 56.7 billion in 2014.

[36] In 2016, a total of 73 employees submitted complaints; all complaints have been resolved (positively or negatively). No court cases are anticipated at this point.

voluntarily left the company in 2017, with similar estimated results in terms of wage bill reduction and education composition changes.

52. **The Government is committed to ensuring the retrenchment is carried out in accordance with applicable laws.** Labor optimization in EPS was voluntary. The company provided generous compensation packages, above the minimum required by the Labor Law, with take up on voluntary separation exceeding targets due to high application rates. EPS established employee support teams to provide information to employees about their rights and the process of downsizing. Grievance redress mechanisms related to the retrenchment process also included representatives of the unions. Going forward, the labor optimization plan for 2016-2019, adopted under DPL1, sets out medium-term targets and timelines for further optimization of the workforce. Considerations of improving productivity through improved staff skills and improving financial sustainability through lowering costs are expected to remain a priority.

Prior Action #5. The Borrower, through the Supervisory Board of Elektroprivreda Srbije (EPS) has:

(a) updated the labor optimization plan for calendar year 2017, including annual targets, compensation packages, eligible categories, selection criteria, and grievance mechanisms for EPS; and
(b) issued the second call for voluntary separations.

53. **Expected results:** In accordance with the targets set in the Labor Optimization Plan, the program targets an increase in the education level of EPS workforce: the share of workers holding secondary education and above is expected to increase by 5 percent between 2015 and 2018, contributing to increased efficiency and containing cost to sustain gains in financial sustainability of the company.

Financial stabilization of Srbijagas

54. **Traditionally, JP Srbijagas has generated significant losses each year which reached a record of EUR392 million (1.2 percent of GDP) in 2014.** Past losses accumulated to such an extent that by end-2015 negative equity (net asset value) of EUR563 million was recorded in JP Srbijagas stand-alone financial statements and total liabilities of Srbijagas amounted to EUR1.62 billion (RSD 197 billion) in December 2015, close to 5 percent of GDP. Given the negative operating results, the company traditionally covered expenses, including its substantial investment program, by assuming new government-guaranteed debt. Accumulation of arrears and an unsustainable investment program were chief reasons for these losses.

55. **The financial stabilization of Srbijagas has been initiated in 2016 and progress has been realized in the financial position of the company in 2016 and 2017.** The Government prepared and adopted a Financial Consolidation Plan (FCP) for Srbijagas in March 2016 (DPL1 Prior Action #6). Measures outlined in the plan postulate the development of a sector strategy, increasing revenues by improving the bill collection rate, reducing the financial burden of the debt obligations, as well as addressing the unprofitable investment plan and weak corporate governance framework of the company. The Government has moved forward in 2016 and 2017 with the implementation of the plan, with an early focus on diminishing the financial burden of loans owed to commercial banks. Twenty-eight commercial loans with banks were renegotiated in 2016-2017 to lower interest rate payments.[37] An additional five

[37] In the case of euro-denominated loans, the renegotiations resulted in reductions of 3 percent to 5.2 percent in the variable part of the loan (variable payment is added to 3-month Euribor). In the case of dollar-denominated loans, the reduction in the variable part ranged from 1.5 percent to 3 percent (variable payment is added to 3-month USD LIBOR).

loans with outstanding principal amounting to RSD4bn (EUR33m) were repaid ahead of schedule.[38] Long term loans fell from EUR657m to EUR276m between 2015 and 2017 and interest payable is EUR10.2m in 2017 (down from EUR70m in 2014). The net profit for 2016 amounted to EUR18m. The amount of debt obligations that Srbijagas has settled from its own resources has increased from EUR32.7m 2016 to EUR42m in 2017. Notwithstanding improvements in the commercial loan situation and a decreasing amount of needed budget support, Srbijagas continues to require significant budget support for the repayment of existing guaranteed loans: budget loans contracted in 2014 amounted to EUR75m (RSD9bn) and were still outstanding in 2017.

56. **To sustain improvements in the financial position of Srbijagas, the DPL2 supports the continued implementation of reforms laid out in the Srbijagas FCP.** These include a government decision supporting the enforcement of payment discipline by setting out mechanisms[39] for discontinuing gas supplies in case of non-payment, and improved economic and financial assessment[40] of the company's investment program so as to reduce uneconomic spending and build-up of related debt via the adoption by Srbijagas management of a company-specific investment appraisal methodology. In addition, the program also supports the appointment of an audit committee to increase the quality of internal controls and internal and external audits via the adoption of a Srbijagas management decision (Prior Action #6). Regarding the enforcement of payment discipline, monitoring of payments due is ongoing: a monitoring table is being published by Srbijagas on its website with monthly updates of the 20 largest debtors. The September 2017 issue shows that the customers monitored (mostly large SOEs) are current on their payments, with total collection rate of 90 percent for the month. Collection rates have improved to 87 percent in 2016 and 86.4 percent in 2017 (first 9 months).[41] Accounts payable decreased from EUR165m to EUR46m between 2015 and 2017. In terms of rationalizing the significant investment program of Srbijagas, technical assistance has been provided by the World Bank throughout 2017 on the development of an evaluation methodology which the company has adopted in December 2017 and an appraisal of the CAPEX program for future investments has been undertaken using the methodology.[42]

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[38] Total loans renegotiated amount to EUR230m and US$150m. Only interest rates, not maturities were renegotiated and all loans remain state guaranteed. Estimated interest payments saved in 2017 are EUR 3.8m on euro-denominated loans and US$3.3m on US dollar-denominated loans. The estimation is based on the remaining months to the maturity and proportional decrease in principals. Several lenders preferred early repayment of outstanding principals which was completed in January 2017.

[39] In order to stop new debt from accumulating and ensure an adequate revenue stream for Srbijagas going forward, a decree was put in place in 2016 declaring that non-payment of gas bills will lead to disconnection of the offending entity. The revenue collection situation has been further stabilized by the fact that the gas supply for two of Srbijagas' largest debtors, MSK and Azotara, has been pre-paid from either their own sources or in the case of Azotara by their buyer, who provides the advance payment directly to Srbijagas based on Surety contract. In case the companies fail to provide advance payments, the Government is supposed to intervene and provide such advances by transfers from the Budget.

[40] Such an economic and financial assessment refers to the definition of a systematic process for examining alternative uses of resources, focusing on assessment of needs, objectives, options, costs, benefits, risks, funding, affordability and other factors relevant to Srbijagas' investments decisions.

[41] Azotara stopped paying the bills in August 2017, violating the pre-payment agreement with Srbijgas and leading to a lesser improvement in collection rates; without Azotara, the collection rate was 88.94 percent the first 9 month of 2017.

[42] The methodology adopted for the appraisal of Srbijagas investment focuses on the financial and economic evaluation; other aspects, notably social and environmental impact assessments are covered under the legal framework for public enterprises.

Prior Action #6. The Borrower, through Srbijagas, has strengthened Srbijagas' financial management through:

(a) the adoption of the Government Conclusion, which defined the mechanisms to discontinue gas supplies to commercial consumers in arrears;

(b) the approval by Srbijagas management of Decision, which adopted a company-specific appraisal methodology for investments; and

(c) the approval by Srbijagas management of Decision, which established Srbijagas' audit committee as the body in charge of the oversight of Srbijagas' system of internal controls.

57. **Expected results** include an increase in the company's collection rate of current receivables from the baseline of 80 percent in 2015 to 87 percent (averaged over 2016-2018), and in 2018 the approval by Srbijagas a 10-year development plan for the gas Transport System Operator and 5-year development plan for the Distribution System Operator in accordance with the economic and financial appraisal methodology adopted under PA#6.

PILLAR C: TRANSPORT PUBLIC ENTERPRISES AND STATE-OWNED COMPANIES

58. **Improving the quality of infrastructure and service delivery in a fiscally conscious way is critical for achieving the goals of the ongoing fiscal consolidation.** According to the 2016–2017 Global Competitiveness Report, Serbia ranked 115th out of 138 countries on the quality of roads and 86th on the quality of its rail infrastructure. The rail sector in Serbia has been characterized by low labor productivity,[43] overstaffing, low railway traffic intensity and a lack of investment in priority network upgrading based on economic efficiency criteria. This is in addition to large needs for network renewal. Without reform, railway operations, with the current size of the network, labor force and assets could not be sustained without significantly more government financial support. In the road sector, inefficient asset management practices, where maintenance contracts are not procured on a competitive basis, the lack of clarity on year to year budgetary allocations for the national road network and a large backlog in rehabilitation needs estimated at about US$1 billion are the main reasons for the unsatisfactory condition of the road network. Across both sectors enhanced efficiency and quality of service delivery require improvements in sector-level policy and governance, as well as in the corporate governance and operational management of the public transport companies.[44]

59. **As a first step, in 2015 the Railway company was unbundled into two operating companies (passenger and freight), an infrastructure manager and a transitional (fourth) company**. The primary role of the transitional (fourth) company is to address the resolution of surplus property that is not state property, and to wind itself down, with a life determined by the time for this process. The Steering Committee adopted a Railway Reform Plan (2016-2020) in October 2015, informed by a 2014 World Bank Railway Policy Note and an EU-funded consultancy report. This plan covers the financial and corporate reform of railway companies and centers on asset disposal, network optimization, and staff rationalization.

[43] Labor productivity was estimated at about 30 percent of the EU-27 average (comparison is with EU-27 instead of EU- 28 because the data is from 2012 before Croatia became the 28th member of the EU). The sum of passenger-km and ton-km divided by total route km was about 30 percent of the EU-27 average – 11 percent for passenger and 54 percent for freight traffic. The figures are not expected to be have changed much since the analysis was carried out in 2012/2013.

[44] See, for example, the 2011 Reform Action Plan for Roads of Serbia prepared under the World Bank supported Corridor X Highway Project and World Bank (2014), Republic of Serbia: Accelerating Railway Reforms in Serbia: A Roadmap.

60. **The policy actions supported under the DPL are key to implementation of the railways' sectoral reform agenda.** Positive progress has been made following the adoption of the reform plans for the railway companies. This included putting in place and operating under the new contractual framework for the sector (supported by DPL1), enabling better targeting of direct budget support to the railway sector. Clear performance criteria in the contracts also help improve service delivery, management accountability for performance, and inform decisions on future network configuration and services. The October 2015 Rail Reform Plan included Key Performance Indicators for the period 2015–2020 for each of the operating and infrastructure companies, with performance criteria included in the respective annual business plans of the new railways companies (DPL1 Prior Action #7).

61. **As of December 2017, the new railway companies are operational.** These include two operating companies: Serbia Cargo and Serbia Passenger (VOZ), the Infrastructure Manager (IZS) and the Joint Stock company (JSC). The companies have completed their second full financial year as independent companies. The two operating railway companies and the Infrastructure company (Cargo, VOZ, and IZS) produce IFRS-compliant annual financial reports. The Government annual support to the sector remains within the level agreed with the IMF under the SBA arrangement. There is a gradual but steady decrease in train-km[45] on the network that is forecasted to continue during the period 2017-2019.

62. **The railway reforms are gradually leading to financially-sustainable railway companies which now require less government budgetary support for infrastructure and public service obligations.** Labor optimization alone is expected to reduce the wage bill for the railway companies by about RSD4.1bn by 2018, compared to 2013. Plans for the rationalization of the railway network by 800 km, together with expected increases in productivity and efficiency are expected to generate additional savings. Despite the reduction in government budgetary support to the railways from RSD13.5bn in 2015 to RSD11bn in 2018, the companies' financial receipts cover their expenditures. In addition, the companies are using the proceeds of the sales of surplus and non-core assets to repay their commercial debts in a manner that does not negatively impact the financial capacity to operate effectively. At present the infrastructure company and the passenger company generate accounting losses estimated at RSD0.5bn due to non-cash expenses (depreciation) in 2017 but these are projected to decline over the next three years. Developing asset management plans for infrastructure and rolling stock, which is the next phase of the reforms, will clearly define asset maintenance and renewal needs and depreciation expenses to help ensure that the companies do not incur accounting losses.

Ensuring financial viability of the railway companies

63. **The DPL2 focuses on the implementation of additional measures to put the new rail companies on a sound financial footing and improve their efficiency**. This is to be achieved largely through efficient debt management and modernization of financial and accounting systems of the railways.

64. **The current debts of the new rail companies are manageable.** The Rail Reform Plan 2016-2020[46] envisaged the new railway companies free of "historic" debt and liabilities. The liabilities of the rail companies can be divided into two categories: (1) State guaranteed loans from IFI and foreign countries (EUR570m, or RSD70bn); (2) Commercial Debt from Commercial Banks, Utilities and Foreign Rail Companies. The currently outstanding commercial debt from commercial banks and foreign rail companies are EUR19.8m divided between Cargo (EUR17.5m) and Passenger Rail (EUR2.3m). Serbia Voz (Passenger Rail) has made significant strides in generating revenue from the sale of surplus assets.

[45] The reduction in train operations on the IZS network is largely driven by (1) capacity limitations imposed by poor condition of infrastructure and (2) ongoing infrastructure works.
[46] Adopted by the Government in October 2015.

Serbia Cargo is successful in making payments toward retiring its allocated share of historic commercial debt, including early payments and a possibility being discussed of using retained earnings to pay off debt. The company generated EUR4.33m from sale of surplus rolling stock since 2015. Cargo has a debt repayment schedule in place.[47] The Infrastructure Company (IZS) has the highest amount of commercial debt, estimated at around RSD9.8bn, consisting of historic liabilities. There has been significant progress with debt reduction: debt towards EPS and other public sector utilities in Serbia was paid off as part of an arrangement whereby Government facilitated a debt settlement process involving several companies in Serbia.

65. **Rail companies are upgrading their financial and accounting systems to facilitate preparation of annual financial statements and for better business management.** Significant allocation of funds has been earmarked by the Rail companies for modernization of their management and financial systems, in the adopted Business Plans.[48]

- **Infrastructure**: Planned procurement of services and goods (section 14 of approved 2018 business plan) lists implementation of Enterprise Resource Planning (ERP) project and purchase of supporting equipment. The budget for ERP pilot services, ERP equipment and other IT equipment, is set at RSD126 m.
- **Cargo**: Planned procurement of phase II of ERP. The approved business plan (allocated funds, Annex 13) shows Cargo's investment of RSD40m while investment Plan (Annex 14) shows the necessary budget at RSD100m. Both documents will be used for Cargo to arrive at its final Procurement Plan 2018 that is in development.
- **Passenger/ Voz:** The approved plan (section 9, Investments) lists the new ERP system. While there is no specific item in the Investment Plan that relates to ERP, the company allocated RSD3m in 2018 for an in-house data center (Annex 14, Investment Plan) as Phase I investment for the upgrade.

Prior Action #7. The Borrower:

(a) through each Railways Company has settled its debt with EPS and issued a plan to restructure its commercial debt in a manner that places the company in a position to be financially viable and started its implementation;

(b) through each Railways Company made publicly available its Annual Financial Statements for calendar year 2016; and

(c) through each Railways Operating Company has allocated resources for the upgrade of its financial and accounting system to allow an effective financial management of the company and application of International Financial Reporting Standards.

66. **Expected results:** As Rail companies commercialize and become more self-sufficient, it is expected that the level of annual direct budget operational support to the Railways Companies will reduce from RSD 13.5 billion in 2015 to RSD 11 billion in 2018. Improvements in labor productivity (measured by train kilometers per employee) and in asset utilization (measured by passengers per kilometer of track and ton per kilometer of track) relative to 2014 both to increase by 15 percent by 2018.

[47] The status of Cargo's debt is as follows: 2 percent repaid, 29 percent reprogrammed and 69 percent of total in the process of being reprogrammed.

[48] Rail Infrastructure Business Plan adopted on December 27, 2017, Rail Passenger/Voz plan adopted on December 15, 2017 and that of the Cargo company adopted on December 13, 2017.

Labor rightsizing in the Railways

67. **Labor rightsizing is an important factor in delivering improved efficiency for the railways companies.** In an important step forward in this process in 2016 the four railway companies adopted Labor Optimization Plans (DPL1 Prior Action #8) setting out the medium-term targets, process, compensation packages, selection criteria, grievance mechanisms and timeline for reductions in staffing. Unions were consulted on the severance packages. Labor rightsizing has been proceeding according to plan and the headcount reduction for the period 2016-2017 totals 5,563. The labor retrenchment effort in 2016 resulted in headcount reduction of 3,007 staff. This was above the target of 2700 staff reduction envisaged for 2016. The headcount reduction in 2017 was in total 2,605 workers (slightly higher than the target of 2,397), including those who retired on a regular basis. The retrenchment process included 2, 410 workers. The reductions in the individual companies are: Infrastructure Manager: 1,720; Cargo: 550; Passenger/Voz: 323; and the transitional company: 12. During retrenchment process about 20 percent of workers were separated involuntarily. There were 453 grievances submitted, of which 150 were adjudicated in favor of the complainant and 303 complaints were dismissed. The resulting 2017 annual decrease in labor cost[49] per rail company is 35 percent at IZS, 33 percent at Cargo, and 23 percent at Passenger/Voz.

68. **The Government is committed to ensuring the retrenchment is carried out in accordance with applicable laws.** Labor optimization in railway companies was about 80 percent voluntary. The companies provided compensation packages above the minimum required by the Labor Law. The Ministry of Labor carried out a review of the retrenchment process in the railways companies in 2016, and found that the process was carried out in compliance with the labor law. During staff downsizing in 2017, the representatives of NES provided input into the retrenchment plans prepared by the railways companies, and explained to the potentially affected workers services NES offers. Railways companies established employee support teams to provide information to employees about their rights and the process of downsizing. Grievance redress mechanisms related to the retrenchment process also included representatives of the unions. Going forward, the labor optimization plans for 2016-2020 adopted by the railway companies under DPL1, set out the medium-term targets, process, compensation packages, selection criteria, grievance mechanisms and timeline for reductions in staffing. It is expected that considerations of increased efficiency and improved financial sustainability will continue to guide the staffing process.

Prior Action #8. The Borrower, through each Railway Company has:
(a) updated its labor optimization plan for calendar year 2017, including the annual targets, eligibility criteria, compensation packages, and grievance mechanisms; and
(b) achieved the targets for calendar year 2017 set forth in said labor optimization plan.

69. **Expected results:** Directly related to the rightsizing of the labor force, reduction in annual wage bill of railways companies is expected in 2018 by 25 percent, relative to that in 2015.

Road rehabilitation, resilience and maintenance

70. **On roads, the focus is on increasing the sector's efficiency through an improved policy framework.** Public enterprise Roads of Serbia (*Putevi Srbije*, PERS) maintains and rehabilitates the National Road network (about 17,000 km) and Motorways (600 km). Because only the motorways are tolled, Roads of Serbia received substantial direct budget support, for the remaining maintenance work,

[49] Based on headcount data as the 2018 business plans are at the approval stage.

equal to 0.2 percent of GDP in 2015.[50] Reforms needed to improve the sector efficiency include the introduction of monitorable service-level agreements between the transport line ministry and Roads of Serbia and introduction of competitive tendering for road maintenance works. A service level agreement (SLA) is a legal agreement that would guarantee predictable budget support (from the ministry) over a multiple year time frame in return for performance guarantee (maintenance levels, minimum standards of operation, performance indicators) from the roads agency.

71. **The Service Level Agreement (SLA) is a legal contractual agreement by which Government provides PERS with mid-term financing in return for agreed performance and upkeep standard of the road network.** This multi-annual contract between Government and PERS will define the level of Government's support for the activities of reconstruction, rehabilitation, upgrade of geometric alignment to increase climate resilience of roads, safety treatments, maintenance, and management of public roads. The SLA implementation will be accomplished in three phases, supported by four complementary World Bank operations, namely The Road Rehabilitation and Safety Project (RRSP), Corridor X highway project, Enhancing Infrastructure Efficiency and Sustainability Program for Results and the proposed Development Policy Loan (DPL). Phase 1: This DPL operation ensured the adoption of the framework, concurrently, the RRSP will support the implementation of the road condition survey for the road network managed by PERS, in order to establish a baseline for pavement and structures condition. Phase 2: The Technical Assistance element of the Corridor X Highway Project will be used to prepare the detailed legal SLA contract, Phase 3: The recently approved "Enhancing Infrastructure Efficiency and Sustainability Program for Results" project calls for negotiations, signature and adoption of the SLA by December 2018, and for the resulting agreed budget support reflected in the State budget. The SLA framework for the medium-term service-level agreement was adopted by PERS Board and endorsed by MCTI. The framework defines clear goals and performance targets linked to secure financing supports improved long-term planning, and should lead to a better quality of investment and asset preservation to ensure resilience in the face of floods and drought cycles, and improved accountability by Roads of Serbia.

Prior Action #9. The Borrower, through PERS, has prepared and approved a framework for a service-level agreement to be entered with MCTI, for purposes of:

(a) defining the performance standards for different road classes, based on pavement conditions, operational standards, and safety;
(b) require the Borrower, through MCTI to provide an agreed financing for roads to achieve the agreed performance standards; and
(c) holding PERS accountable for agreed performance standards.

72. **Expected results:** The SLA framework will enable MCTI to specify the performance level of the road network managed by PERS in return for predictable and sustainable budget support. This predictability will enable PERS to start looking long term in its planning and to address strategic issues such as long term resilience of its network to minimize human and economic loss due to severe climatic events of frequent floods and drought experienced.

ANALYTICAL UNDERPINNINGS

73. **The design of the proposed DPL series and the proposed prior actions are informed by substantial recent and ongoing TA and analytical work, undertaken with strong collaboration with**

[50] Starting from 2012, the financing model for the roads changed with some revenues from tolls and excises redirected from the company to that of the government budget. The budgetary transfers have been lower than what Roads of Serbia used to receive through the excise tax on fuel.

other development partners. Table 5 indicates specific sectoral work which complements the overarching analysis in the recent Serbia Public Finance Review and SCD reports.

Table 5. DPL Prior Actions and Analytical Underpinnings

Prior actions	Analytical Underpinnings
PA#1 on Budget Inspection, PIFC Strategy, and budget execution	2015 PEFA report and World Bank Input to the Government' PFM Reform Program highlighted need to improve arrears monitoring, payment discipline and ex ante commitment controls.
PA#2 on the Law on Ceiling on Public Sector Employees and institution-level limits on employees	World Bank wage system TA and TA for preparation of the Modernization and Optimization of Public Administration PforR highlighted fragmentation of wage system and need for staffing limits and controls. Serbia Rightsizing and Restructuring Project, funded by the EU Commission, supports preparation of series of functional reviews aimed to identify options for optimization and rightsizing in the public sector.
PA#3 on the Law on the Salary System of Public Sector Employees and associated legislation	
PA#4 on guaranteed supply tariff increase while protecting vulnerable consumers	World Bank TA to EPS to support the preparation of the FCP (finalized) and updated in 2016 and 2017 outlined measures to support financial sustainability of company, including tariff rises and reductions in labor costs through rightsizing process. TA: Energy Affordability, Tariff Increase, and Protection of Vulnerable Populations in Serbia carried out quantitative analysis to assess the implementation of the ongoing Energy Vulnerable Customer program and highlighted the need for additional funding, implementation challenges and provided policy recommendations to address these.
PA#5 on EPS labor optimization plan	
PA#6 on strengthening financial management of the Srbijagas	Extensive TA to Srbijagas provided analysis to inform measures set out in the FCP. Specific issues analyzed included: (a) financial due diligence, (b) corporate governance, (c) market analysis, (d) options for debt restructuring, and (e) analysis of the distribution sector. In 2017, TA was implemented to assist Srbijagas in the development of an evaluation methodology for future investments and to assess its current CAPEX program at distribution and transmission level.
PA#7 on railway companies financing policy and business performance criteria	The World Bank Accelerating Railway Reform in Serbia 2014 set out an action plan for sector and corporate governance reforms to improve sector efficiency; EU-funded consultancy in 2015 developed detailed recommendations for improvements in institutional and corporate performance of the rail sector. These were preceded by several TAs financed by the EU and the EBRD that provided a sound analytical framework to guide preparation of Public Service Obligation contracts for passenger transport, Multi-Annual Infrastructure Contracts, Track Access Charge regime and asset management plans.
PA#8 on railway companies labor optimization plans	
PA#9 on a service level agreement (SLA) for national roads	Technical assistance in 2011 for the preparation of a Reform Action Plan for PERS under the Corridor X Highway project. The Action Plan specified the need for an SLA between the line ministry and the PERS.

4.2 LINK TO CPF, OTHER BANK OPERATIONS, AND THE WORLD BANK GROUP STRATEGY

74. **The proposed DPL series contributes to the World Bank CPF FY16-20 Focus Area 1: Economic Governance and the Role of the State and its related objectives**. The CPF was approved in June 2015 with the goal to support Serbia in creating a competitive and inclusive economy and, through this, to achieve integration into the EU. More specifically the CPF sets two focus areas for support: 1. Economic Governance and the Role of the State; and 2. Private Sector Growth and Economic Inclusion. This DPL series contributes to the first CPF focus area, cutting across four of the five objectives of the focus area, namely (i) supporting sustainable public expenditure management, (ii) assist in creating a

more effective public administration and improving service delivery, (iii) more efficient and sustainable power utilities, and (iv) more efficient public transport companies.

75. **The design of the DPL series reflects lessons learned from previous DPL operations in Serbia and energy, transport sector and public sector reform programs**.[51] The DPL series is firmly anchored in recent World Bank analytical work and TA, including those listed above and the recently completed Systematic Country Diagnostic and Public Finance Review. In addition, it builds on knowledge and expertise from recent projects, including the Floods Emergency Recovery Loan. Several Technical Assistance (TA) projects support the achievement of development objectives, including the Enhancing Corporate Financial Reporting TA, under which there is a component focused on the diagnostic and strengthening of the Government's monitoring system over SOEs. There is also the International Finance Corporation's program for strengthening corporate governance in SOEs and a close coordination with the IMF SBA.[52] Finally, the need to address policies or programs aimed at mitigating the adverse social impacts potentially caused by the transition is another important lesson of earlier SOE restructuring efforts in Serbia and elsewhere.

76. **Strong complementarity is built into this DPL series with the SOE Reform DPLs, the PforR on Modernization and Optimization of Public Administration, and the Competitiveness and Jobs project.** The series complements the Program-for-Results (PforR) operation on Modernization and Optimization of Public Administration[53] which supports implementation of the key legislative and policy reforms under the Pillar A of the PEPU DPL. Pillars B and C are strongly complementary to the SOE Reform DPL series[54] which supported accelerated restructuring and divestiture program for the PA portfolio and selected commercial SOEs; strengthened governance, regulatory and institutional framework, and monitoring and transparency arrangements for these SOEs; and mitigated the social and labor market impact of the SOE reform program. The third related operation is the Competitiveness and Jobs project[55] which aims to facilitate job creation and to strengthen the capacity of the NES; to improve the effectiveness of active labor market programs; and facilitate the transition of social assistance beneficiaries into formal jobs. Operations such as the PforR on Enhancing Infrastructure Efficiency and Sustainability complementing reforms in the road sector, the Corridor X Highway Project and the Road Rehabilitation and Safety Project are supporting road sector reforms.

4.3 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

77. **The Government has designed their reform agenda through a consultative process.** Most of the reforms supported by this operation have been developed including consultations organized by the Government, for example on the broad ERP and the PFM Reform Program. For the public administration rightsizing, steps are being taken to improve the consultation process, which is part of the Action Plan in the World Bank-supported PforR program. Electricity price increases followed consultation and public awareness process established by the regulator.

78. **On the labor rightsizing measures, the Government has involved respective unions in the reform process.** The public sector rightsizing covers a broad range of sectors and type of workers (for

[51] See, for example, the 2011 Second Programmatic Public Expenditure DPL on lessons learned from DPL lending in Serbia since 2000 and the overarching lessons learned from the FY12–FY15 Serbia CPS Completion and Learning Report.
[52] See IMF Relations section.
[53] See, World Bank. 2016. *Serbia - Program on Modernization and Optimization of Public Administration (Report No. 104182-YF).* Washington, D.C.: World Bank Group. The Program was declared effective on December 16, 2016.
[54] First operation approved by the Board in March 2015, the second in October 2016.
[55] Board approval in September 2015.

example, workers with the status of civil servants in the ministries, and workers to which labor law and various collective agreements apply in health, education, public services). Unions were involved in consultation around the adoption of the Law on the Ceiling on Public Sector Employees in 2015. In the case of rightsizing at EPS, unions participated in various stages of the process including negotiating voluntary compensation packages, involvement in the Call for voluntary applications and as members of the Employees support teams. The entire rightsizing process in EPS in 2016 is based on the voluntary separation of workers, who will retire upon termination of employment with EPS. In the case of the railways companies, unions participated in the negotiations around severance packages and the selection criteria for the retrenchment. The Labor Optimization plan contains a stipulation that the application of involuntary separations will be carried out in collaboration with the unions.

79. **This operation is prepared in close coordination and cooperation with relevant stakeholders, including development partners**. The World Bank team has collaborated and consulted closely with other development partners, including the EU, EBRD, and IMF, with regular exchange of information and participation in joint meetings with technical counterparts, contributing to the design of the program. World Bank support to PFM and public administration reforms is closely coordinated with the IMF and the EU.[56] Electricity sector reforms in particular are coordinated with the IMF and with EBRD. Specifically, in 2015 the EBRD extended a EUR200 million restructuring line to help EPS to restructure its balance sheet and support the implementation of policy actions, complementary to those supported under the DPL, aimed at improving the commercialization of the company, raising standards of corporate governance and improving energy efficiency. Policy actions and World Bank analysis in the energy and transport sectors have also helped inform the dialogue under the IMF program on issues such as company rightsizing, financing policy, debt restructuring, and electricity price increases, among others. In railways, in addition to the World Bank, a number of IFIs, including the IMF, are supporting the sector's reform and restructuring, with the EU financing supporting TA. IFIs, including also the EIB and the EBRD, are invited to meetings of the high level Railway Reform Steering Committee.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

80. **Some of the DPL prior actions will have adverse distributional and social impacts in the short run, though mitigating measures are in place and the overall poverty impact is expected to be limited.** These include workforce rightsizing in the public administration, EPS, and public railways companies, but the overall poverty impact is expected to be limited given the income profiles of affected workers and mitigating measures such as compensation packages, programs of employment support, and labor regulations. The inflation-equivalent increase in electricity costs in 2017 is not expected to have a significant impact, while continuing the protection of vulnerable populations through the targeted Energy Vulnerable Customers Program would help address energy affordability concerns among poor and vulnerable consumers. The legislations related to the Public Sector Wage System are not expected to have significant adverse distributional impacts to the extent that the implementation includes only the re-categorization of public workers and no adverse salary adjustments.

Poverty and Social Impacts of Prior Actions Relating to Labor Rightsizing

81. **The labor rightsizing in the public administration, EPS and Railways Companies can adversely impact affected workers.** As mentioned above, the reduction in public administration workers focused on the health, education and social protection sectors and local public enterprises, including staff

[56] For example, the PfoR program supports the same government program (though different aspects of it) as the EU's Sector Budget Support instrument and the EU Commission also provides funding for the functional reviews to identify options for optimization and rightsizing in the public sector.

reductions in EPS (5,000 workers over 2015 to 2019) and Railways Companies (3,007 workers in 2016 and 2,556 in 2017). Quantitative analysis to inform the PSIA, based on company records and household surveys, shows that potentially affected workers tend to be located in the middle and top quantiles of the income distribution and that they are not amongst the most vulnerable (See Annex 5 for more details). However, workers and their families will be affected. While educated, workers in rail and EPS tend to be older and in the same position for a long time. They may not have the right skills set to be competitive in today's challenging labor market. Some workers, particularly from railways companies, are located in small towns or in regions (for example, in Southern and Eastern Serbia) where the prospects of finding new employment can be weak. Previous qualitative research of workers retrenched from the Privatization Agency companies suggests that their best chances of reemployment would be in informal casual jobs. Data from the National Employment Services (NES) indicates that about five percent of railways workers retrenched in 2016 found new employment. More than a thousand received counseling and training support from NES.

82. **The Ministry of Labor carried out a review of the retrenchment process in the railways companies in 2016, and found that the process was carried out in compliance with the labor law.** During staff downsizing in 2017, the representatives of NES provided input into the retrenchment plans prepared by the railways companies, and explained to the potentially affected workers services NES offers. Both EPS and railways companies established employee support teams to provide information to employees about their rights and the process of downsizing. Grievance redress mechanisms related to the retrenchment process also included representatives of the unions. Labor optimization in EPS was voluntarily, while in railways companies about 80 percent of affected workers left voluntarily.

83. **Serbia has in place a relatively well developed policy and legal framework on labor relations and retrenchment along with an institutional system which is generally adequate, although some gaps exist**. Serbia's legal framework is generally in line with international standards. Existing labor legislation provides adequate protection of workers in instances when due to technological, economic or organizational changes a particular job becomes redundant or volume of work would be reduced. In such cases, the Labor Law requires that the employer prepare a retrenchment plan, which must be consulted upon with Unions, with Laws and collective agreements provide provisions for redundancy (severance) payments and formulas for its calculation.

84. **To minimize adverse effects on affected workforce, the design of the Labor Optimization plans for EPS and the railway companies was informed by the domestic policy and legal framework and international good practice**. The EPS and railways' labor optimization plans rely as much as possible on retirement and voluntary applications for separation. Workers who opt for early retirement will also receive stimulative packages. In the case of involuntary separation, or workers who are declared redundant due to business reasons, workers will receive compensation packages above the minimum required by the Labor Law and will have the right to receive unemployment benefits from the NES, health insurance and pension benefits for the period while they are registered with NES. Also, the retrenchment plans set out grievance mechanisms and clarify timelines and responsibilities for the processes (with EPS having established a separate grievance unit within the legal department, for example).

85. **The NES has already in place specific measures to support retrenched workers and its capacity and effectiveness is being strengthened.** This category of unemployed persons is considered one of the priority groups for the NES. Measures of support include job search counseling, trainings for prequalification, psychosocial support and opportunities to participate in public works. In 2017, 1,586 retrenched railway workers registered with NES and participated in their programs.

Poverty and Social Impacts of Higher Electricity Costs and Protection of Vulnerable Customers

86. **The 2017 increase in household (guaranteed supply) electricity tariffs by 2 percent nominal (or zero percent in real terms) is expected to have a very limited adverse impact.** Energy affordability is a concern for many poor households in Serbia. Earlier electricity tariff increases in 2015 and 2016, a cumulative price increase of 16 percent, were significant and expected to have increased poverty (using an anchored relative poverty line of 60 percent of median household income) from 15.0 percent to 16.0 percent. However, in 2017, the tariff increase supported by PA4 of this DPL corresponded to only the rate of inflation and was not expected to have significantly affected purchasing power to the extent that nominal income also increased. Even a 2-percent price increase without income increase is simulated to have an impact of less than 0.1 percentage point on the poverty rate and on the share of electricity spending in total household budget.

87. **Mitigating measures are in place to protect vulnerable households against high energy expenditures.** Serbia's social protection system includes a number of income support programs such as poverty-targeted social assistance (Financial Social Assistance, or FSA) and categorical programs for specific groups such as child allowances and disability benefits. In addition, the Government continues to implement the existing energy bill discount program for certain categories of social assistance beneficiaries and low-income households (supported under the DPL). To maintain protection of vulnerable households, the Government: (i) enhanced administrative guidance in 2016 to support local self-governments as the implementing authorities and (ii) relaxed the asset criteria in 2017 to increase eligibility for rural elderly people. The inter-ministerial working group, which was established in 2015 to develop a new Decree on Energy Vulnerable Customers, has continued to convene to monitor the program implementation and discuss options for improvement. The program will maintain the same design and implementation arrangements in 2018. With a similar allocated budget as in 2017, the program is estimated to maintain its coverage of around 70,000 households.

Gender Dimensions

88. **Some of the impacts discussed are expected to vary by gender.** With respect to rightsizing measures, in EPS and railways companies roughly 80 percent of the labor force are men. With support from ESMAP, the Bank is in the process of designing gender diversity program in EPS which aims to increase the percentage of women in the technical positions, and middle management roles. This program will include training and mentoring for female employees, and a set out outreach of activities to high schools and universities to encourage participation of young women in science, technology, engineering, and mathematics (STEM) education. The National Action Plan for Employment for 2017 included persons over the age of 50 and redundant workers as a priority group. Women are prioritized in the participation in employment measures. Female-headed households (close to a third of households in Serbia), including elderly women living alone, are more vulnerable to the energy price increases. Maintaining protection through the energy bill discount program as supported by the DPL is important to cushion the impacts, including for female-headed households.

5.2 ENVIRONMENTAL ASPECTS

89. **Overall the reform policies supported by the DPL series are not likely to have significant effects on the environment, forests and natural resources.** By supporting the electricity tariff rises, which help correct distorted price signals (Prior Action 4), the operation is likely to generate environmental benefits through improved energy efficiency. Energy and carbon intensity in Serbia are high compared to the other Southeast Europe countries, given the large share of fossil fuel (particularly lignite) in their mix. Gradually adjusting the electricity prices for households and small and medium enterprises will create incentives to move toward the more efficient use of electricity, including discouraging use of electricity for heating purposes, and hence provide potential climate change

mitigation co-benefits. Potential negative environmental impact of energy prices adjustments, through additional pressure on other fossil fuels such as coal and wood by vulnerable households, is assessed as negligible, given relative cost of fuels, prevailing housing conditions that are not conducive to such switch, and availability of social protection programs. Improvements in operational efficiency in railways and quality of roads are likely to result in more efficient fuel use, thus contributing to environmental sustainability.

90. **The transport sector reforms supported by the DPL series are also expected to generate climate change mitigation and adaptation benefits.** At present, the railway companies are unable to meet their financial obligations and repay their commercial debt, a situation which inevitably results in the deterioration of the infrastructure. This deterioration will in turn result in traffic shifting from rail to road. By placing the companies in a financially viable situation (Prior Action 7), the railway companies will be able to implement the railway track renewal program and reduce modal shifts from rail to road mitigating GHG emissions. The adoption of the framework SLA (Prior Action 9) is also expected to generate partial climate change benefits related to adaptation associated with rehabilitation, reconstruction, and climate retrofit works that increase resilience of the road network. The SLA will introduce climate resilience standards in the design of road rehabilitation increasing the transport network's ability to better cope with extreme weather events. The floods in May 2014 resulted in significant damage to the transport infrastructure in Serbia. Damages to national and local roads were estimated at US$51m and US$32m, respectively. In addition, losses associated with the flooded roads were estimated at US$73m. The regular occurrence of floods continues to represent a substantial livelihood risk in Serbia which has led Government to establish a national risk management system. This is not an isolated incident as recent studies indicate that Serbia is particularly sensitive to future climate and precipitation change, with weather-related events expected to become more frequent and intense.[57]

91. **The overall legal and regulatory framework for addressing the environmental damage and liabilities is deemed adequate, although implementation is often hampered by institutional and financial capacity constraints.** Serbia has made progress toward alignment of its policies with the EU environmental acquis, and is planning opening negotiation on Chapter 27 during 2018. In the position paper for Chapter 27, it is recognized that further efforts are needed to strengthen the administrative capacity and implementation framework for management of environmental risks.[58] The Law on Environmental Protection (LEP) establishes the legal framework for environmental protection, and includes provisions for environmental impact assessment, integrated pollution prevention and control (IPPC), nature protection, air, water, soil protection, and waste management which are regulated by separate laws and by-laws.[59] However, implementation and enforcement practices in Serbia vary and are not always fully aligned and consistent with regulatory provisions for environmental protection. The legal obligations in respect to environmental management, monitoring and reporting on national and local levels are well defined and financial allocations in this respect exist. However, overseeing and efficiency of utilization of these funds on local level are fully within the authority of local government institutions. In this regard, the establishment of the Ministry of Environmental Protection is a step forward in bringing

[57] Climate Change 2013: The Physical Science Basis. Contribution of Working Group I to the Fifth Assessment Report of the Intergovernmental Panel on Climate Change [Stocker, T.F., D. Qin, G.-K. Plattner, M. Tignor, S.K. Allen, J. Boschung, A. Nauels, Y. Xia, V. Bex, and P.M. Midgley (eds.)]. Cambridge University Press, Cambridge, United Kingdom and New York, NY, USA.)

[58] For further analysis see World Bank (2015). *Serbia - First Programmatic State Owned Enterprises Reform Development Policy Loan Program Project*.

[59] The LEP has a number of provisions concerning environmental liabilities, notably based on the principle of polluters' and legal successors' liability, which stipulate that any legal or natural entity that is involved in activities negatively affecting that is, damaging the natural environment is liable and that the polluter or its legal successor is responsible for eliminating the cause of pollution and related direct or indirect consequences.

these issues to the forefront of policy reforms and to increase government's capacity for implementation and monitoring.

92. **The implemented labor rightsizing measures in EPS, Serbian Railways and Roads of Serbia are not expected to have detrimental impact on the capacity to efficiently address historical and ongoing stock of environmental liabilities.** The analysis undertaken confirmed that these companies will continue to have sufficient number of positions in their environmental departments to ensure adequate environmental capacity, in accordance with the relevant national laws. Process of ISO 9001 and ISO 14000 certification will continue in EPS, together with implementation of Environmental and Social Action Plan (ESAP) as a part of already agreed obligations for EBRD's involvement in company restructuring. The investment appraisal methodology adopted by the management of Srbijagas includes environment criteria by complying with the national environmental laws. The issues that warrant further monitoring include (i) creation of central unit responsible for environmental, health, safety and fire protection functions at central level of EPS, in accordance with ESAP; (ii) development of clear lines of responsibilities and communication between the central an local units in EPS related to environmental management of hazardous waste; (iii) Resolution of issues related to long-term storage of hazardous waste in Serbia Cargo; (iv) Implementation of recommendations of Corporate Governance Plan (expected in first half of 2018) calling for streamlining and strengthening of risk, energy efficiency and environmental unit in Serbia Railways; (v) provision of adequate operating budget for implementation of environmentally-related measures in calendar 2018 and 2019.

5.3 PFM, DISBURSEMENT, AND AUDITING ASPECTS

93. **The assessment of the country's PFM system in relation to designing disbursement and auditing arrangements for the loan is based on the available diagnostic work in this area in Serbia.** It primarily builds on the 2015 Public Expenditure and Financial Accountability (PEFA) assessment as well the functional review of the MoF conducted in 2016, relevant chapters of EU Progress Reports, annual SIGMA assessments of public expenditure management and public internal financial control, and in-country reports, such as those by the Fiscal Council. Disbursement and auditing arrangements have been determined based on the prevailing fiduciary environment, standard procedures for DPL disbursements and previous experience with similar operations in Serbia.

94. **As discussed above, a number of reforms have been undertaken aiming to make PFM more efficient, but there is a need for further improvements.** The Government has undertaken a number of PFM reforms, making efforts to strengthen treasury operations and financial controls, legislative and institutional framework, budget classification and coverage, internal and external audit. These reforms are encouraging, strengthening the transparency, accountability and control framework. However, challenges remain, as highlighted in the 2015 PEFA Report, and Public Internal Financial Control (including internal audit and financial management and control) still has a long path to cross in order to respond to EU requirements in the accession process. Nevertheless, the existing inherited system of internal controls is not so weak to represent a major risk for the operation.

95. **Execution of the budget is operated by the Treasury and established processes, controls and procedures provide sufficient assurance about budget execution system.** The annual budget is published and available on the internet. The Budget is executed for payments through the Consolidated Treasury Account (CTA) operated by the Treasury. Functioning of the CTA is assessed to be reliable with adequate controls instituted, and statements and reconciliations produced on daily basis. So far, foreign currency accounts have been held in the National Bank of Serbia, but the reform to integrate foreign currency within CTA is under way. Payments are done within budget appropriations (defined by either the original or supplementary budget), and there are hard system controls which prevent payments to exceed annual budget appropriations by a given budget beneficiary. In terms of cash and liquidity

management, each budget beneficiary is assigned with a payments quota for the coming quarter which is revised every month, and similarly payments exceeding such quotas do not get processed.

96. **Financial controls have been gradually strengthened in recent years.** While the Public Internal Financial Control (PIFC) framework has been established by provisions of the Budget System Law, functions of internal audit and financial management and control in practice still require significant development. Internal audit has been established in a majority of public sector entities but further efforts to increase its effectiveness are needed. A financial management and control (FMC) function is yet to be established in a large number of entities and written procedures either do not exist or are not applied in practice. The State Audit Institution (SAI) has come a long way in terms of staffing and coverage of audited public expenditures but further challenges remain in expanding the number of audited entities and responding to broad scope of audits mandated by legislation. The SAI completed the audit of 2016 annual financial statements of the Government, and issues identified in previous years persist, e.g. lack of appropriate systems of internal controls, deficient information on non-financial assets and compliance with public procurement law.

97. **The control environment and procedures applied in the NBS and the Treasury are considered adequate.** As per the Bank's assessment of NBS and the Treasury system, the institutional and operational arrangements had been deemed reliable. Based on the assessment, since 2012 designated accounts for all Bank's loans are opened in the NBS. Annual independent financial audits of the NBS do not identify any significant issues either. The auditors issued a clean (unmodified) opinion on the NBS financial statements for 2016. Audits conducted by the SAI, as well as diagnostic assessments, likewise show that Treasury operating is one of the strengths of the country's PFM system.

98. **This operation is a single-tranche loan to the Republic of Serbia.** The loan proceeds will be made available to the Borrower upon the effectiveness of the Loan Agreement between the Bank and the Republic of Serbia and compliance with the withdrawal tranche release condition. The loan is included in the Law on Budget for 2018. The proposed loan will follow the Bank's disbursement procedures for DPLs. Upon approval of the loan and notification by the Bank of the effectiveness of the Loan Agreement between the Bank and Republic of Serbia, the Borrower will submit a withdrawal application to the IBRD. The IBRD will deposit the proceeds of the loan into a foreign currency deposit account that forms part of the country's official foreign exchange reserves, designated by the Borrower, to be held at the NBS. This account will be managed by and subject to control of the MoF. The Borrower shall ensure that upon the deposit of the Loan into said account, that it is available to finance budgeted expenditures and the management of public debt, and is accounted for in the budget execution system.

99. **No audit of the deposit account will be required, but rather a confirmation letter to be provided.** The MoF will provide IBRD with written confirmation that the loan proceeds were received in an account of the government that forms part of the country's official foreign exchange reserves, and an equivalent amount has been accounted for in the country's budget management system. This confirmation letter should be delivered within 30 days of the receipt of loan proceeds. No additional arrangements to mitigate fiduciary risks, such as audit, are required as the disbursement arrangements are confined to the NBS and CTA. The confirmation letter related to disbursement of funds for the first programmatic operation has been received timely and in adequate form.

5.4 MONITORING, EVALUATION, AND ACCOUNTABILITY

100. **The Ministry of Finance is responsible for overall monitoring and assessment of the implementation of the proposed reform agenda and for coordinating actions with other concerned ministries and agencies.** In addition to the Ministry of Finance, Ministry of Public Administration and Local Self-Government, Ministry of Energy and Mining, and the Ministry of Construction, Transport and Infrastructure, key entities directly responsible for implementing the supported program include EPS,

Srbijagas, Railways, and Roads of Serbia. The Ministry of Energy is leading an inter-ministerial working group to monitor the implementation of EPS FCP with a Railway Reform Steering Committee also guiding and monitoring related reforms. The reforms under the DPL are key elements in a range of strategies and action plans with their own results framework and monitoring mechanisms, for example, the broad Economic Reform Program and the Public Administration and PFM Reform Action. Progress on the rightsizing measures is particularly closely monitored by the Government and respective entities, as well as the related PforR operation.

101. **The World Bank monitors the status of the project implementation through supervision missions and tracking results indicators**. Through regular missions, the World Bank is tracking the results indicators provided in the policy and results matrix (Annex I) based on the economic and legislative data provided by the various government agencies and committees and disclosed in official sources. The PforR operation also has a detailed monitoring framework - and disbursement linked indicators – concerning public administration reform measures.

102. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

103. **The overall risk rating of this operation is Substantial, unchanged from DPL1, and mitigated by the EU accession process and strong commitment to reforms, supported by a range of partners.** The overall rating is determined by substantial political and governance risks. These are compounded by the complexity and depth of the reform program supported by the DPL and that result in substantial implementation, social and stakeholder risks. On the other hand, macroeconomic and fiduciary risks as well as those related to sector strategies and policies and technical design are considered moderate (Table 6). The risks are mitigated by the Government's overarching strategic objective of EU accession, which implies an acceleration of the structural reforms. These reforms are also supported by the World Bank and other development partners. These arrangements mitigate political, macroeconomic and capacity risks.

104. **The reforms supported by this DPL series require strong political will to implement, resulting in high relevance of political and governance risks.** The 2016 elections returned a coalition Government to power which has since implemented a series of transformational reforms. But early Parliamentary elections in 2017 slowed down implementation of the key reforms. There is a probability that the same situation will repeat itself in 2018, triggered by the upcoming elections in the city of Belgrade. The Government's demonstrated strong commitment to tackling reforms in the areas of focus of the DPL, as well as the overall strengthening of its strategic vision with a goal of EU accession and strengthened economic growth, mitigate these risks. In addition, the pull factors for accession have recently been strengthened, with the Western Balkans being made the topic of both the Bulgarian and

Austrian presidencies of the EU, reflected in a recent speech of the EU President suggesting Serbia could be ready to enter the Union in 2025.

Table 6. Systematic Operations Risk Rating (SORT)

Category	Risk	Rating (H, S, M or L)
1	Political and governance	S
2	Macroeconomic	M
3	Sector strategies and policies	M
4	Technical design of project or program	L
5	Institutional capacity for implementation and sustainability	S
6	Fiduciary	M
7	Environment and social	S
8	Stakeholders	S
9	Other	n/a
	Overall	**S**

Source: World Bank staff.

105. **Implementation risks are also Substantial.** Implementation of the proposed reforms under the DPL will strain the institutional capacity of respective ministries and public utilities, which are also moving forward on a broader set of demanding reforms including the EU accession process. To mitigate these risks, the Government has mobilized extensive TA and support from the World Bank, the EU, and other development partners, for example, through this DPL series and the World Bank operations discussed earlier. This is in addition to support from other partners in these areas, particularly the EU.

106. **Stakeholder risks are rated as Substantial.** Tariff reform and reform in energy and transport companies faced strong resistance in the past due to strong power groups (for example, unions) and a lack of confidence that the increased revenues (through higher tariffs) and cost reduction (including labor rightsizing) would benefit the broader population. To mitigate these risks, the operation supports measures aimed at improving transparency and accountability mechanisms. In addition to a strengthened program to protect vulnerable population supported under the DPL series, the Government is also committed to implement communication measures to better inform the broader population on the need for electricity tariff adjustments. There is a high risk that affected employees and more broadly unions in energy and transport companies oppose the rightsizing program. Unions are powerful groups which could pose strong opposition, and eventually, reverse reform. To mitigate this risk, the rightsizing programs in rail and EPS have been discussed with the respective unions, with further consultation through implementation needed.

107. **Social risks are also Substantial.** Social risks are substantial given the content of this Operation's program that includes labor retrenchment in the public utilities sectors. As highlighted in Section 4.1, the rightsizing and electricity tariff reforms are expected to have potential adverse distributional and social impacts in the short run. While mitigating measures are in place, as detailed in Section 4.1, and the overall poverty impact is expected to be limited, the residual social risk is substantial.

ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions		Results*
Completed under DPO 1	**Completed under DPO 2**	(End of the calendar year unless otherwise specified)
PILLAR A: PUBLIC EXPENDITURE MANAGEMENT **Program Development Objective A: Improve public expenditure management through strengthened PFM and public administration reform**		
Prior Action #1. The Borrower, through its Ministry of Finance, adopted the framework for monitoring the implementation of the Law on Deadlines for Payments in Commercial Transactions, which has been revised to extend its coverage to include public-public transactions, including those of state-owned enterprises.	Prior Action #1. The Borrower has: (a) issued the Decree on Work and Role of Budget Inspection, to strengthen the budget inspection supervision and enforcement function; (b) adopted the PIFC Strategy and its associated action plan, to provide a framework for planned future developments of financial management and control and internal audit functions; and (c) through its Ministry of Finance, amended the Rulebook on the Budget Execution System, in order to ensure that accurate, complete and up-to-date information on budget commitments are available at the time when budget commitments are incurred.	Results Indicator A1. Share of executed payments for public to public commercial transactions which were beforehand duly registered as commitments within deadlines prescribed by legislation: • Baseline (end-2015): 60 percent • Target (end-2018): at least 90 percent
Prior Action #2. The Borrower: (a) adopted the Law on the Ceiling on Public Sector Employees setting the criteria of determining the maximum number of employees in the public sector, from 2015 to 2018, as well as the scope and limits for reducing their number in order to achieve the established said maximum; and (b) established, as required by said law, the first institution-level limits on the number of employees in the public sector.	Prior Action #2. The Borrower has updated institution-level limits on employees in the public sector for calendar year 2017.	Results Indicator A2. The number of employees in the public sector, as determined by the Law on the Ceiling on Public Sector Employees, does not exceed the total of institutional-level limits set under the Law and its decisions: • Baseline (end-2015): no • Target (end-2018): yes
Prior Action #3. The Borrower adopted the Law on the Salary System of Public Sector Employees to rationalize the public sector pay structure.	Prior Action #3. The Borrower has: (a) amended the Law on Public Sector Employees Salary System; (b) enacted the Law on Employees in Public Services; and (c) enacted the Law on Salaries of Employees in Bodies of Local Sub-Government Units and Provincial Authorities, all with the objective to provide the legal framework for the mapping of positions between the Public Sector Jobs Catalogue and the new pay grades set forth in the Law on Public Sector Employees Salary System.	Results Indicator A3. Increased share of positions within the education, health and social protection sectors mapped to new grades: • Baseline (end-2015): zero • Target (end-2018): 75 percent

Prior Actions		Results*
Completed under DPO 1	**Completed under DPO 2**	(End of the calendar year unless otherwise specified)
PILLAR B: ENERGY PUBLIC ENTERPRISES **Program Development Objective B: Improve the financial sustainability and efficiency of energy sector public enterprises**		
Prior Action #4. The Borrower: (a) through its Council of the Energy Agency, approved a 3.8 percent increase of the electricity tariff for guaranteed supply; (b) amended the Energy Vulnerable Customers Program to increase coverage of targeted beneficiaries; and, (c) increased the budget for said program.	Prior Action #4. The Borrower, through the Council of the Energy Agency, has approved an increase of the electricity tariff for guaranteed electricity supply in calendar year 2017 and continued to protect vulnerable households from such electricity tariff increase by increasing the number of beneficiaries of the Energy Vulnerable Customers Program in calendar year 2017 compared to calendar year 2016.	Results Indicator B1. Increased convergence of the guaranteed electricity supply tariff to reach market parity levels: • Baseline (end-2014): 64 percent • Target (end-2018): 80 percent[60] Results Indicator B2. Increased number of total beneficiaries of the Energy Vulnerable Program: • Baseline (2014 annual): 60,600 households; of which 27 percent female headed households • Target (2018 annual): 70,000 households; of which 30 percent female headed households
Prior Action #5. The Borrower, through the Supervisory Board of *Elektroprivreda Srbije* (EPS): (a) adopted a labor optimization plan for 2016-2019 setting out the medium-term targets, process, compensation packages, selection criteria, grievance mechanisms and timeline for reductions in staffing; and (b) issued the first call for voluntary separations to implement the 2016 target for net staff reduction.	Prior Action #5. The Borrower, through the Supervisory Board of Elektroprivreda Srbije (EPS) has: (a) updated the labor optimization plan for calendar year 2017, including annual targets, compensation packages, eligible categories, selection criteria, and grievance mechanisms for EPS; and (b) issued the second call for voluntary separations.	Results Indicator B3. Increase in the share of the EPS workforce with education above secondary-level relative to 2015: • Baseline (2015): zero • Target (2018): 5 percent
Prior Action #6. The Borrower adopted a financial consolidation plan for *Srbijagas* that defines measures to increase revenues and reduce costs.	Prior Action #6. The Borrower, through Srbijagas, has strengthened Srbijagas' financial management through: (a) the adoption of the Government Conclusion, which defined the mechanisms to discontinue gas supplies to commercial consumers in arrears; (b) the approval by Srbijagas management of Decision, which adopted a company-specific appraisal methodology for investments; and (c) the approval by Srbijagas management of Decision, which established Srbijagas' audit committee as the body in charge of the oversight of Srbijagas' system of internal controls.	Results Indicator B4. Increase in *Srbijagas*' collection rate of current receivables: • Baseline (2015): 80 percent • Target (average 2016-2018): 87 percent Results Indicator B5 - The approved *Srbijagas* 10-year development plan for the Gas Transport System Operator and 5-year development plan for the Distribution System Operator are in accordance with the adopted economic and financial appraisal methodology: • Baseline (2016): No • Target (2018): Yes

[60] See paragraph 49 in Section 4.1 of this Program Document for further detail.

Prior Actions		Results*
Completed under DPO 1	**Completed under DPO 2**	(End of the calendar year unless otherwise specified)
PILLAR C: TRANSPORT PUBLIC ENTERPRISES AND STATE-OWNED COMPANIES **Program Development Objective C: Improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies**		
Prior Action #7. The Borrower: (a) implemented a new framework for railways financing through conclusion of the track access contracts between the state-owned infrastructure rail company and the state-owned freight and passenger rail companies and approving a public service obligation agreement; and (b) adopted new performance criteria for the state-owned infrastructure, freight and passenger rail companies.	Prior Action #7. The Borrower, through: (a) each Railways Company has settled its debt with EPS and issued a plan to restructure its commercial debt in a manner that places the company in a position to be financially viable and started its implementation; (b) each Railways Company made publicly available its Annual Financial Statements for calendar year 2016; and (c) through each Railways Operating Company has allocated resources for the upgrade of its financial and accounting system to allow an effective financial management of the company and application of International Financial Reporting Standards.	Results Indicator C1. Level of annual direct budget operational support to the Railways Companies: • Baseline (2015): RSD 13.5 billion • Target (2018): RSD 11 billion Results Indicator C2. Improvements in labor productivity (measured by train kilometers per employee) and in asset utilization (measured by passengers per kilometer of track and ton per kilometer of track) relative to 2014: • Baseline (2015): zero • Target (2018): 15 percent (for both indicators)
Prior Action #8. The Borrower: (a) through the Decisions of the General Assemblies of the respective railway companies, adopted labor optimization plans for 2016-2020 setting out the medium-term targets, process, compensation packages, selection criteria, grievance mechanisms and timeline for reductions in staffing; and (b) through the management of the respective railways companies, initiated the 2016 target for staff reduction by communicating to the companies' respective employees the option for their participation.	Prior Action #8. The Borrower, through each Railway Company has: (a) updated its labor optimization plan for calendar year 2017, including the annual targets, eligibility criteria, compensation packages, and grievance mechanisms; and (b) achieved the targets for calendar year 2017 set forth in said labor optimization plan.	Results Indicator C3. Reduction in annual wage bill of railways companies relative to 2015: • Baseline (2015): zero • Target (2018): 25 percent
	Prior Action #9. The Borrower, through PERS, has prepared and approved a framework for a service-level agreement to be entered with MCTI, for purposes of: (a) defining the performance standards for different road classes, based on pavement conditions, operational standards, and safety; (b) require the Borrower, through MCTI to provide an agreed financing for roads to achieve the agreed performance standards; and (c) holding PERS accountable for agreed performance standards.	Results Indicator C4. The government agrees with Roads of Serbia on performance levels for the different road classes with associated guaranteed funding levels committed: • Baseline (for 2016 budget): no • Target (for 2019 budget): yes

Note: * Additional information on the results indicators is provided in the respective discussions in Section 4.1.

ANNEX 2: LETTER OF DEVELOPMENT POLICY

MINISTRY OF FINANCE

Dr. Jim Yong Kim

President

The World Bank

1818 H Street, N.W.

Washington, D.C., 20433

Belgrade, January 9, 2018

REF: Letter of Development Policy

Second Public Expenditure and Public Utilities Development Policy Loan

This letter summarizes in a selective manner critical aspects of the program that the Government of Serbia is committed to undertake over the short and medium term to support a multi-year fiscal consolidation agenda and transformation of energy and transport sector public enterprises and State-Owned Enterprises (SOEs). This includes measures to improve public expenditure management through strengthened public financial management and public administration reform, improve the financial sustainability and efficiency of energy sector public enterprises, and improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies.

This program supports the objectives of economic policy originally set by the Government's 2016-2018 Fiscal Strategy and its 2016-2018 Economic Reform Program[1], and the Memorandum of Economic and Financial Policies, agreed with the IMF. This medium-term plan of structural reforms, together with measures of fiscal consolidation, is a key basis for (1) maintaining public finances stable by reducing the fiscal deficit and public debt, (2) faster economic growth based on the increase in investments, exports and employment.

Macroeconomic framework and key structural reforms

The Government of Serbia adopted on November 29th 2017 the new *Fiscal Strategy for 2018–2020,* which outlines economic policy for the medium-term. The main goals of our economic policy are:

[1] Including the preliminary list of structural reforms to be included in the ERP 2017-19 which was put for public consultations in October 2016.

continuation of the fiscal consolidation measures to ensure macroeconomic stability, curb the growth of public debt and put it on a downward path; increasing the stability and resilience of the financial sector, including by resolving the issue of non-performing loans; continue implementing a comprehensive set of structural reforms to improve competitiveness and ensure sustainable economic growth, in particular through the reforms of the state owned enterprises and improving the efficiency of the public sector. The goals of the economic program are compatible with our aspirations to become an EU member, having started the accession negotiations process in December 2015.

Over the medium-term, we expect that growth will accelerate to an average of 3.7 percent, inflation is expected to stay within the NBS target band, and the balance of payments is foreseen to further improve. To control the fiscal deficit and to reduce the public debt further, we will continue with implementation of a fiscal consolidation program and structural reforms initiated under the just completed three year IMF Stand-by Arrangement (SBA). The IMF SBA was approved in February 2015, and the final review was completed and endorsed by the Board in late December 2017. The program has been supporting the necessary fiscal adjustment, while the design and implementation of key structural reforms has been done jointly with the World Bank and other IFIs. We will continue to implementation of complementary economic and institutional reforms needed to foster growth, improve competitiveness, and increase exports and investment across the economy. Furthermore, we expect that the improved global and EU economic outlook will have a positive impact on economic activity and employment in Serbia, as the EU remains our main trading partner and source of FDI.

Since the global financial crisis of 2008, Serbia went through three recessions and struggled to restore its pre-global-crisis growth pace. Average growth of 5.9 percent recorded between 2001 and 2008, was reduced to 0.2 percent since then as the economy contracted by 3.1 percent in 2009, by 1 percent in 2012 and by 1.8 in 2014. While the 2009 recession was mainly due to the severe impact of the international financial crisis, recessions in 2012 and 2014 were primarily caused by natural disasters – a drought in 2012 and severe floods in 2014. We are putting additional effort to address the adverse impact of natural disasters on our economy.

We were encouraged by the economic recovery in 2016 leading to 2.8 percent GDP growth, the highest since the 2008 crisis. More importantly, the growth was driven mainly by exports which increased by 12 percent in real terms and marked a shift towards a much-needed export led growth model. On the supply side, the 2016 growth was broad based as all sectors recorded significant increases in output and value added – agriculture by 8.1 percent y/y; industry by 2.6 and services by 2.7 percent, y/y.

High unemployment, a longstanding issue for Serbia, is benefiting from recent economic recovery. The unemployment rate which peaked at 23.9 percent in 2012 has declined to a 13.1 percent average for the first three quarters of 2017. During 2016 wages increased by 3.7 percent y/y in nominal terms and continued to grow 4.1 percent during the January-November 2017. Another positive feature of wage developments in 2017 is the faster growth of private sector wages (4.7 percent) than public sector wages (3.2 percent y/y).

The growth momentum from 2016 could not be sustained in 2017 due to supply side conditions. The weather (cold winter followed by severe drought) negatively affected electricity production, construction sector and agriculture yields resulting in lower than anticipated GDP growth. Hence, the original growth projections for 2017 have been revised down from 3 to around 2 percent. It is important to note that the

slowdown is not the sign of recession but represents the negative impact of exogenous factors entirely on the supply side. Most notably, poor performance of the power sector (coal production and power generation) was triggered by adverse weather conditions early in the year. Similarly, long winter followed by severe draught negatively affected agriculture. This explains the brunt of the growth slowdown in the first three quarters of 2017 estimated at 1.5 percent y/y.

External imbalances are expected to gradually narrow with the current account deficit set to decline to 3.9 percent of GDP by 2020. Improvements in the trade deficit will continue based on better export performance due both to stronger recovery in the EU, main destination for Serbian exports, and recent foreign direct investments which broadened the export base and increased the domestic content of Serbian exports. The traditional surplus in services will continue to increase gradually. FDI (net), attracted by better business environment and the progress of reform, are projected to 5-6 percent of GDP and to markedly exceed the current account deficit.

We expect that inflation will remain within the NBS target band. Monetary policy will continue to be implemented through an inflation targeting framework combined with a flexible exchange rate (with any intervention focusing on managing excess currency volatility). In November 2016, NBS announced that the inflation target for 2017 through end-2018 would be 3±1.5 percent, a lowering of the target mid-point by one percentage points due to improved macro fundamentals, as well as softer inflation expectations of the corporate and financial sectors.

Over the medium term, we are committed maintaining a low overall fiscal deficit, averaging 0.5 percent of GDP. Expenditures are projected to gradually decline (by about 1.5 percentage point) over the medium term) mainly due to further savings in current expenditures. Reduction in current expenditures will more than offset a projected increase of capital expenditures (from 3.0 percent of GDP in 2017 to 3.7 percent in 2020). The revenue-to-GDP ratio is set to decline gradually from 43.9 percent of GDP in 2017 to 41.1 percent in 2020.

According to the latest Fiscal Strategy, public debt-to-GDP is projected to fall from about 63 percent (projected for end 2017) to approach 56 percent by 2020. We will continue with prudent fiscal policy even after the current IMF program expires in 2018, which will result with the primary surplus of around 2 percent of GDP over the next couple of years. Therefore, public debt will fall below 60 percent of GDP.

This macroeconomic outlook is supported by a detailed set of reform measures as reflected in the most recent Fiscal Strategy. The program hinges on the better control of public spending, including on the public sector wage bill and subsidies to SOEs. Therefore, we remain committed to the expenditure measures introduced so far, and will continue to observe the limits for increase in public sector wages and pensions, as well as reducing state aid to state-owned enterprises (SOEs).

Over the previous year, we have adopted and started implementing several important legislative and regulatory changes which will underpin our structural reforms and contribute to a comprehensive program to enhance Serbia's completeness and business environment. Our ultimate goal is to support investment, job creation and private sector development. Some of these measures include:

- Amendments to set of laws governing employment in order to further increase labor market flexibility;

- Amended the legislation governing education system at all levels;
- Amendments to the Law on Bankruptcy, adopted in December 2017, to set clearer rules and streamline procedures.
- Introduction of across the board e-payments of taxes, significantly easing the administrative burden on enterprises.
- We ratified several regional treaties in order to further promote cooperation across the Western Balkans.

Program of Reforms on Public Expenditure and Public Utilities

The government is committed to transforming Serbia into a fully functioning market economy with a vibrant private sector. As set out in the Fiscal Strategy 2018-2020, this includes structural reforms focusing on the real and public sector respectively.

Through ongoing reforms, and the support of this Public Expenditure and Public Utilities DPL series and related operations, the Government and the Ministry of Finance is committed to improving the management of public finance and moving forward with public administration reform to reduce expenditure on employees through addressing the number and structure of employees in the government sector and reform of the system of salaries. We are also committed to taking measures to ensure financial sustainability of energy companies and improving the efficiency in public transport companies, helping to support reductions in budget support to public and state-owned enterprises.

This DPL series complements the programmatic SOE DPL Series which aims to improve the governance, transparency and accountability of SOEs that will remain in government ownership, restructure and divest from non-competitive enterprises, reduce the fiscal burden imposed by the commercial SOEs, contribute to improved business environment and competitiveness of Serbia's economy, while supporting and compensating those workers who will be adversely affected by this process. It also complements other recently operations with the World Bank and other partners, including the WB Competitiveness and Jobs Project, the Program-for-Results (PfR) operation on Modernization and Optimization of Public Administration, and the PfR on Enhancing Infrastructure Efficiency and Sustainability.

Improve public expenditure management

i) Strengthened public financial management

The objective of the recently adopted Program of Public Finance Management Reform (PFMR) from 2016 to 2020 is to provide a comprehensive and integrated framework for the planning, coordination, implementation and monitoring of progress in the implementation of sustainable activities so as to improve macroeconomic stability, ensure efficient and purposeful deployment and use of public resources for the realization of the national priorities and improve the services provided by the government administration in the Republic of Serbia, while increasing transparency and the overall

functionality of the public finance management and fulfilment of the necessary conditions for accession to the European Union (EU).

In order to strengthen financial discipline in the public sector, the effect of the Law on Payment Deadlines in Commercial Transactions (often referred to as the RINO Law) was extended by amendments to the Law in July 2015, so that it also applies to transactions among public sector institutions. Amended provisions of the Law apply as of 1 January 2016, with monitoring mechanisms set out in a Rulebook adopted in October 2015. The Law establishes monitoring and control mechanisms of applying the provisions relating to payments between units of the public sector. The mechanisms that enable consistent implementation of the Law relate to, among other things, reduction in transfers from the budget, where the measure may be applied, or in case that the state-owned or public enterprise receives some form of support from the budget, as well as penalties for the responsible persons determined in accordance with the Law. The Rulebook regulates how the supervision over the implementation of the law will be conducted by the Budget Inspection Unit of the Ministry of Finance for transactions which involve public sector entities. The rulebook on supervision of the implementation of the RINO law is enforced as the Budget Inspection Unit collects data from the relevant Treasury systems, analyzes them and takes concrete steps. However, the full positive impact of the RINO Law and accompanying by-laws is subject to further constraints, such as unconfirmed accuracy and completeness of reported data by public sector entities, within three days of incurring the commitment as prescribed by legislation. Improved reporting discipline as the implementation period is longer and the sanctions and on-site visits of the Budget Inspection are applied to larger number of entities is expected to help address this issue. In addition, supplemental steps could lead to the solution of the issues, such as additional features in the FMIS not allowing executing payments for untimely recorded commitments, additional secondary legislation ensuring accuracy and timeliness of reporting on outstanding commitments and arrears by users of public funds, raising awareness training for the users of public funds etc. Accurate information on commitments and arrears is vital for the credibility of budget formulation and budget execution processes. We will also establish a new e-invoice system covering the public sector based on a unique invoice code that would be required at the time of invoicing.

ii) Public administration reform

Public administration reform is one of the main elements of structural reforms to achieve long-term sustainability of public finance and establish a sound business environment. This includes measures to reach the objective of the fiscal policy in the medium term is to reduce expenditures for employees on a sustainable level of 7% of GDP, as defined by the Law on Budget System.

To ensure better organization of public administration and improve the quality of services, while also supporting fiscal consolidation, progress has been made on the labor rightsizing process. The Law on the Ceiling on Public Sector Employees, which was adopted in July 2015 is a legal basis for the manner of determining the maximum number of public sector employees in the public sector, in the period from 2015 to 2018. The Law also defines the scope and limits of reducing the number of employees in order to achieve the established maximum number of employees in the public sector in line with the expected improvement of their productivity to which should come after the reorganization. The Decision on the Maximum Number of Public Sector Employees for 2015, was passed by the Government on 2 December

2015, while the Decision on the Maximum Number of Public Sector employees for 2017 was adopted on July 13, 2017. As of end 2017, public sector employment (including local public utilities) has been reduced by about 28,500, compared to the end-2014 level, mostly through attrition. More recently available data indicates that employment has continued to decline. While generally applying the 5:1 attrition rule through 2017 for the public sector, we are analyzing options for targeted recruitment and hiring in areas critical for quality of service delivery and efficient management of EU accession process. The Government continues with implementation of recommendations from horizontal and vertical functional reviews, conducted in partnership with the World Bank. The implementation of this reform is supported by the EU Sector Budget Support and by the Bank's Program for Results on Modernization and Optimization of Public Administration.

The Government is taking necessary steps to reform the system of salaries in the government sector in order to reduce inequalities in salaries, and creating equity through introduction of the principle of equal pay for equal work. The Government has adopted a Catalogue of Job positions in public sector in July 2017. With the adoption of the Law on Amendments of the Law on Public Sector Employees Salary System and the Law on Employees in Public Services in December 2017, 70% of all positions in public sector will be aligned with the new pay grades as stipulated by the Law on Public Sector Employees Salary System.

Improve the financial sustainability and efficiency of energy sector public enterprises, in particular Elektroprivreda Srbije – EPS (Serbia's national electric power utility) and JP Srbijagas

As part of the reform of public enterprises, we plan to restructure large systems in transportation and energy sectors, directing them towards market principles of operation, namely: JP EPS "Electric Power Industry of Serbia", JP "Srbijagas" and "Serbian Railways". At the proposal of relevant ministries, the government has adopted programs of corporate restructuring of these large systems in order to improve their organizational structure and management system, as well as reducing the negative impact on public finances and the rest of the economy

In July 2015, the Plan of Corporate Restructuring for PE EPS was adopted with focus on simplifying the organizational structure and management and rationalization of the number of employees in order to avoid the need for state aid in the future. In June 2015, a Financial Consolidation Plan was adopted, which was prepared in cooperation with the World Bank and the European Bank for Reconstruction and Development (EBRD), with the goal to create a profitable company capable of responding to market challenges in terms of both quality and price. The basic elements of the Plan are as follows: increase in revenues through improved collection and decrease in costs through increased efficiency, optimization of the procurement process and reducing the number of employees. Following household tariff increase of 4.5 percent in August 2015, 3.8 percent in October 2016, and 2 percent in October 2017, we expect to reduce the financing gap and narrow the difference between domestic and regional market levels. We have also taken steps to support households impacted by higher energy prices, adopting a new Decree on Energy Vulnerable Customer in December 2015 and increasing the budget allocation for the program in 2016 to RSD 1.65 billion, up RSD 680 million in 2015. We have seen an increase in the number of beneficiaries under the protection program of energy vulnerable households from about 60,000 in 2014 to 70,000 in August 2017. We are committed to continue collaboration with the local government entities administering the program to strengthen its implementation effectiveness. We are continuing to analyze

progress in the implementation of other measures in the FCP and regional electricity prices, with this analysis informing future electricity tariff increases.

Consistent with the five-year rightsizing target specified in the financial restructuring plan, the EPS supervisory board has adopted in August 2016, in consultation with the World Bank, a credible 2016-19 labor optimization plan targeting a reduction in labor costs by end-2019 of 15 percent compared with 2015 levels. This plan will be carried out in order to achieve social sustainability of the employee downsizing model and, together with broader social protection systems and labor policies implemented by the government, is expected to mitigate negative social impacts. Implementation of the labor rightsizing is ongoing: during the first round of calls for applications in October 2016, 1,517 employees voluntarily left the company, resulting in a net reduction in employee numbers of 2,005 taking into account the natural attrition of 488. During the second round of calls in September 2017, the net workforce reduction target of 1,000 workers was surpassed as the number of voluntary applicants reached 1,570. We are committed to continuing the program of labor rightsizing to deliver on the targets of the optimization plan and support the financial sustainability and efficiency of EPS.

PE "Srbijagas" has been a significant source of fiscal risk primarily through its high levels of debt, almost all of which have a government guarantee. A new organizational restructuring plan for the company, adopted in December 2014, started to be implemented in June 2015 and we are working with the Energy Community to finalize the required unbundling of the company. A financial consolidation plan, prepared with the support of the World Bank, was adopted for Srbijagas in March 2016, with the emphasis on measures for achieving long-term financial sustainability and competitiveness. Payment discipline has improved following the adoption of the financial consolidation plan for Srbijagas and collection rates have improved to 87% in 2016 and 86.4% in 2017 (first 9 months).

To lower the fiscal cost associated with servicing Srbijagas' commercial loans, we have refinanced existing liabilities at more favorable terms. Eighteen commercial loans with banks were renegotiated in November 2016 to lower interest rate payments and an additional four loans were repaid ahead of schedule resulting in estimated interest savings for 2017 of about RSD 700 million, improving the cash flow position of Srbijaagas. In order to stop Srbijagas from accumulating arrears going forward and improve collections, a government conclusion came into effect in early 2017 to ensure follow-through on the company's disconnection policy for commercial consumers in arrears. To further stabilize Srbijagas financial situation, we have conducted in 2017 an economic and financial review of the investment plan of Srbijagas. In November 2017, with a support of the Ministry of Mining and Energy, management of Srbijagas adopted investment appraisal methodology for assessment of medium-term transportation and distribution capital expenditure plans with the objective to rationalize CAPEX spending. These measures will improve Srbijagas' financial position and put the company on a sustainable path, thus containing the need for additional state aid.

In order to improve corporate governance of the company, Srbijagas has established in July 2017 an audit committee in line with the requirements of the Law on Public Enterprises. The audit committee is expected to enhance company's risk management, financial reporting, applied system of internal controls, internal and external audit.

Improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies

In order to improve the governance in the rail sector, the efficient utilization of the railway network, the overall quality of the rail transport service, as well as to limit budgetary support to SOEs, it was of primary importance to reorganize the Public Enterprise Železnice Srbije (Serbian Railways) in accordance with the principles of efficient and sustainable operation, and in light of best EU practices.

To this end, we established a Railway Reform Steering Committee, led by the Deputy Prime Minister and including senior representatives and observers from relevant Ministries and entities, IFIs, and EU, to provide overall direction of the reforms. The unbundling of the company into separate passenger, freight, infrastructure, and a fourth company, became effective from August 2015. The corporate restructuring plan was centered on surplus asset disposal, network re-optimization, settlement and restructuring of debts for financial viability and staff rationalization. Importantly, the freight section has received no further subsidies and has operated on a purely commercial basis from August 2015.

To support market competition, we adopted all the necessary acts in order to allow network access to private operators in February 2016, and the first contract with a private operator was signed in June 2016. The contractual relationships and financial policies of the new system (between the state and the companies and across the companies) have been set out. This includes track access contracts between the railway companies, the Multi-Annual Infrastructure Contract and the Public Service Obligation (PSO) Contract which were adopted by the Government in January 2016 and signed in February 2016. When it comes to the description of new performance criteria, the PSO contract for the first time in the Republic of Serbia introduced responsibilities of the railway passenger operator (regarding the specification of the rolling stock, personnel, regularity of railway transport on PSO lines, safety measures etc.) with specified measures if the same were not fulfilled. In accordance with the Multi-Annual Infrastructure Contract, the rights and obligations of the infrastructure and the Government are regulated, including the sanctions for breach of the contract. Also, this contract governs financing costs of managing the public railway infrastructure, defines the amount needed for maintenance of the railway infrastructure, and the organization and regulation of rail transport, providing access for usage of the railway infrastructure to all interested parties, providing telecommunication services as well as services of electricity transmission in connection with traffic on railway and defines the key performance indicators. The business plans of the operating railways companies also contain new key performance indicators to support improved accountability and performance management.

The companies just completed their second full financial year as independent entities. All three railway operating companies (Cargo, VOZ, and IZS) produce IFRS-compliant annual financial reports. The GoS annual support to the sector remains within the level agreed with the IMF within the active SBA arrangement. There is a gradual but steady decrease in train-km[2] on the network that is forecasted to continue during the period 2018-2019.

[2] The reduction in train operations on the IZS network is largely driven (1) capacity limitations imposed by poor condition of infrastructure and (2) ongoing infrastructure works.

We are implementing the Railway Reform Plan (2016-2020) which was adopted in October 2015 and developed in consultation with the World Bank, EBRD and EU. The Railways Reform Steering Committee adopted a conclusion in June 2016 (end-March structural benchmark) which defines the rightsizing targets for 2016 (involving a reduction of 2,700 staff positions). The General Assemblies of the four companies adopted in early September and October 2016 the Labor Optimization plans setting out the process and targets for reducing staffing levels, as well as the compensation packages and for redundant employees, selection criteria and timeline, with the plans updated in November 2016. The companies have been moving forward with the next steps in the labor optimization process including surveying employees and preparing Retrenchment Programs. By December, 2016, employees taking a severance package had exceeded 100 percent of the 2016 targeted numbers for staff reduction (total reduction in 2016 was 3,146 staff position). Similarly, by December 31, 2017, the headcount reduction was an additional 2556. This included workers who retired on a regular basis. This reduction is higher than the target of 2397. There was a large number of involuntary separations. There were 453 grievances submitted, of which 150 were adjudicated in favor of the complainant and 303 complaints were dismissed. The retrenchment progress has exceeded targets for both 2016 as well as 2017.

We made positive progress in other areas to ensure that the new operating companies are able to operate from a solid financial starting point that included addressing the burden of the historical commercial debt of the companies. Debt towards EPS and other public sector utilities in Serbia was paid off as part of an arrangement whereby the Government of Serbia facilitated a debt settlement process involving several companies in Serbia. This internal debt settlement has been very positive for the rail companies. The outstanding commercial debt owed to commercial banks, foreign rail companies etc, has either been paid off, is in the process of restructuring or has been restructured. The GOS has decided to fully assume liabilities of all state guaranteed loans from IFIs and foreign governments. The companies have made significant strides in implementing modern financial and accounting systems.

Reform of PERS (Roads of Serbia) is being implemented in cooperation with the World Bank. The World Bank approved on October 25, 2016additional funding of EUR 35 million and a closing date extension to June 30, 2018 for the Corridor X Highway Project. As part of additional financing, Component 3: "Implementation Assistance and Institutional Support" will be increased to grant EUR 3 million for technical assistance to the reform of the PE "Roads of Serbia". The corporate and financial restructuring plans for Roads of Serbia will look at the expenditure and revenue side and corporate structure of Roads of Serbia, and also provide recommendations for improvement of the current practices and knowledge in the sector. This includes, but is not limited to, adopting a plan for removing rigidities in pricing maintenance contracts and introduction of performance based contracting on 3000 km of network, revision of the adequacy of the toll rates, recommendations regarding design standard and practices, etc. Reform of the Roads launched in 2016 are underway.

Being fully aware of the high unemployment rate and unfavorable labor market situation, we have carefully designed significant measures to cushion the social and labor impact of our structural reforms, across the above areas, and particularly also for the resolution of commercial SOEs. In particular, our goals are to ensure adequate financial support to workers that will be made redundant, and to facilitate the transition into employment and provide a temporary safety net for vulnerable redundant workers. Support to the National Employment Service in the efforts to strengthen its capacity and improve services for the unemployed is being provided by the World Bank (including through results-based financing loan on Competitiveness and Jobs) and other partners, like the EU. Last but not the least, as envisaged by the 2016-2018 Economic Reform Program adopted by the Government and presented to the European Commission, we will improve the adequacy of financial social assistance by linking the different sectors' information systems to ensure that clients have access to their social rights without administrative barriers and that the overall social assistance is better targeted. To this end we are preparing a new Law of Social Protection which will replace the existing legislations that governs the eligibility and conditions to receive social assistance.

Sincerely,

Dušan Vujović

Minister of Finance

Republic of Serbia

ANNEX 3: FUND RELATIONS ANNEX

IMF Executive Board Completes the Eighth Review of Serbia's Stand-By Arrangement

December 20, 2017

- Program remains on track and is supporting improved confidence, rising investment, and stronger growth.
- Authorities implemented ambitious fiscal adjustment, which has placed public debt on a rapid downward trajectory.
- Further progress with implementing the structural reform agenda is critical to secure sustainable growth and a faster convergence.

The Executive Board of the International Monetary Fund (IMF) on December 20, 2017 completed the eighth review of Serbia's economic performance under the Stand-By Arrangement (SBA). The completion of the review will make available the cumulative amount of SDR 880.835 million (about €1.05 billion). The Serbian authorities have indicated their intention to continue treating the arrangement as precautionary.

The Executive Board approved the 36-month, SDR 935.4 million (about €1.2 billion at the time of approval) SBA for Serbia on February 23, 2015 (see Press Release No. 15/67). The arrangement will expire on February 22, 2018.

Following the Executive Board's decision, Mr. Tao Zhang, Deputy Managing Director and Acting Chair, issued the following statement:

"Serbia has made significant progress under the Fund-supported economic program. Confidence in the economy has improved, public debt is declining rapidly, external position is robust, and investment and growth are stronger. In addition, labor market conditions continue to improve. Significant progress has also been made in implementing the structural reform agenda.

"Continued prudent policies and implementation of structural reforms, especially deeper institutional reforms, are critical to secure sustainable growth and a faster convergence with Western European living standards.

"The authorities have implemented an ambitious fiscal adjustment, which has placed public debt on a rapid downward trajectory. The 2018 budget allows for some employment-friendly tax reductions, while providing fiscal space for needed capital spending. Reforms should continue to achieve better public infrastructure, improve public administration and delivery of public services, and achieve more effective social protection.

"Monetary policy has succeeded in keeping inflation under firm control and is supporting the economic recovery. The current state-contingent approach to monetary policy is appropriate considering domestic and external uncertainties. The exchange rate flexibility demonstrated recently is welcome, with some overall appreciation reflecting Serbia's improved fundamentals and market conditions.

"Financial sector reforms under the program have strengthened banks' resilience, and put them in a much stronger position to support the economy. Efforts to reduce NPLs are yielding good results and need to continue, while reforms of state-owned financial institutions need to be accelerated.

"The significant progress with structural reforms has strengthened Serbia's growth potential and job creation, and reduced fiscal risks. Nevertheless, substantial work remains in SOE governance, management, and investment as well as public administration. Serbia's business environment has improved due to both macroeconomic stability and a better regulatory environment. Further efforts are needed to address problem areas for businesses, including taxes and parafiscal charges, and delays and uncertainty in the judicial system.

"The approaching completion of the program will mark a successful macroeconomic adjustment and a significant strengthening of Serbia's economic capacity."

IMF Communications Department

http://www.imf.org/en/News/Articles/2017/12/20/pr17515-eighth-review-of-serbia-stand-by-arrangement

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant positive or negative environment effects (yes/no/to be determined)	Significant poverty, social or distributional effects positive or negative (yes/no/to be determined)
PILLAR A: PUBLIC EXPENDITURE MANAGEMENT **Program Development Objective A: Improve public expenditure management through strengthened PFM and public administration reform**		
Prior Action #1. The Borrower has: (a) issued the Decree on Work and Role of Budget Inspection, to strengthen the budget inspection supervision and enforcement function; (b) adopted the PIFC Strategy and its associated action plan, to provide a framework for planned future developments of financial management and control and internal audit functions; and (c) through its Ministry of Finance, amended the Rulebook on the Budget Execution System, in order to ensure that accurate, complete and up-to-date information on budget commitments are available at the time when budget commitments are incurred.	No	No
Prior Action #2 The Borrower has updated institution-level limits on employees in the public sector for calendar year 2017.	No	Yes, negative[61]
Prior Action #3. The Borrower has: (a) amended the Law on Public Sector Employees Salary System; (b) enacted the Law on Employees in Public Services; and (c) enacted the Law on Salaries of Employees in Bodies of Local Sub-Government Units and Provincial Authorities, all with the objective to provide the legal framework for the mapping of positions between the Public Sector Jobs Catalogue and the new pay grades set forth in the Law on Public Sector Employees Salary System.	No	No
PILLAR B: ENERGY PUBLIC ENTERPRISES **Program Development Objective B: Improve the financial sustainability and efficiency of energy sector public enterprises**		
Prior Action #4. The Borrower, through the Council of the Energy Agency, has approved an increase of the electricity tariff for guaranteed electricity supply in calendar year 2017 and continued to protect vulnerable households from such electricity tariff increase by increasing the number of beneficiaries of the Energy Vulnerable Customers Program in calendar year 2017 compared to calendar year 2016.	Yes, positive[62]	Yes, negative[63]
Prior Action #5. The Borrower, through the Supervisory Board of Elektroprivreda Srbije (EPS) has: (a) updated the labor optimization plan for calendar year 2017, including annual targets, compensation packages, eligible categories, selection criteria, and grievance mechanisms for EPS; and (b) issued the second call for voluntary separations.	No	Yes, negative[64]

[61] Refer to Annex 5 and Section 5.1 for more detail.
[62] The increase in electricity tariff is also expected to have positive environmental impact and bring climate co-benefits, see Section 5.2.
[63] Refer to Annex 5 and Section 5.1 for more detail.
[64] Refer to Annex 5 and Section 5.1 for more detail.

Prior Action #6. The Borrower, through Srbijagas, has strengthened Srbijagas' financial management through: (a) the adoption of the Government Conclusion, which defined the mechanisms to discontinue gas supplies to commercial consumers in arrears; (b) the approval by Srbijagas management of Decision, which adopted a company-specific appraisal methodology for investments; and (c) the approval by Srbijagas management of Decision, which established Srbijagas' audit committee as the body in charge of the oversight of Srbijagas' system of internal controls.	No	No
PILLAR C: PUBLIC TRANSPORT COMPANIES **Program Development Objective C: Improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies**		
Prior Action #7. The Borrower, through: (a) each Railways Company has settled its debt with EPS and issued a plan to restructure its commercial debt in a manner that places the company in a position to be financially viable and started its implementation; (b) each Railways Company made publicly available its Annual Financial Statements for calendar year 2016; and (c) through each Railways Operating Company has allocated resources for the upgrade of its financial and accounting system to allow an effective financial management of the company and application of International Financial Reporting Standards.	Yes, positive[65]	No
Prior Action #8. The Borrower, through each Railway Company has: (a) updated its labor optimization plan for calendar year 2017, including the annual targets, eligibility criteria, compensation packages, and grievance mechanisms; and (b) achieved the targets for calendar year 2017 set forth in said labor optimization plan.	No	Yes, negative[66]
Prior Action #9. The Borrower, through PERS, has prepared and approved a framework for a service-level agreement to be entered with MCTI, for purposes of: (a) defining the performance standards for different road classes, based on pavement conditions, operational standards, and safety; (b) require the Borrower, through MCTI to provide an agreed financing for roads to achieve the agreed performance standards; and (c) holding PERS accountable for agreed performance standards.	Yes, positive[67]	No

[65] This action is expected to bring climate co-benefits, as by placing the companies in a financially viable situation it allows to implement the railway track renewal program and reduce modal shifts from rail to road mitigating GHG emissions, see Section 5.2.

[66] Refer to Annex 5 and Section 5.1 for more detail.

[67] This action is expected to bring climate co-benefits for adaptation, as though the adoption of the framework it introduces climate resilience standards in the design of road rehabilitation increasing the transport network's ability to better cope with extreme weather events, see Section 5.2.

ANNEX 5: ADDITIONAL ANALYSIS OF POVERTY AND SOCIAL IMPACT

1. **This annex provides additional information on the potential poverty and social impact of the DPL prior actions.** It focuses on quantitative analysis of the prior actions relating to labor rightsizing in EPS, the railways companies and public administration and the electricity tariffs adjustments. Discussion of mitigating measures and the overall PSIA is provided in Section 5.1.

Poverty and Social Impacts of Labor Rightsizing in EPS, Railways Companies and Public Administration

2. **Public workers potentially affected by the labor rightsizing in the public administration, EPS and railways companies are not the most vulnerable groups in Serbia's population.** An analysis based on the companies administrative records and household surveys show that overall poverty impacts would be limited, especially in the short run, since the potentially affected public workers are not the most vulnerable population. Workers in public administration, EPS and public railway companies, as a whole, are older and more educated than in the formal and informal private sector. Salaries are higher than in similar positions in the private sector, especially in EPS. They are in a better position than former SOE workers from the PA companies, which were rationalized in their vast majority a few years ago. However, although rightsizing in the public sector has received considerable public awareness in recent years, preparation of workers in advance for the possibility of losing their employment may be lower, on account of the stability of employment enjoyed until very recently (in contrast, most PA companies liquidated a few years ago were carrying arrears in their salaries and many companies were de-facto liquidated before formally laying off workers). In terms of welfare, workers from the three affected groups are not poor nor in a particular vulnerable position, though workers in transport are slightly less well-positioned. In general, the workers tend to be located in the mid to top quintiles of the distribution, and other vulnerability indicators (for example, single earners, household composition, health status) seem to be consistent with what is observed among formal private sector workers and better than the informal sector (Table 5.1).

3. **Nonetheless, it is still important to acknowledge that workforce rationalization will have an important social cost on wellbeing of the retrenched workers and their families, and previous experiences indicate that it is very difficult for them to find new permanent positions.** The immediate loss of a significant income source from public wages, unless compensated with a fair severance package, would imply a negative shock to household income in those families. More than a third of public workers report to be the only employed person in the household, and particularly for transport workers, a significantly higher share relies on public wage as the only source of income. The profile of these workers suggest that while educated, they tend to be older workers in the same position in the public sector for a long time, and may not have the right skills set to be competitive in a labor market already stagnant with high unemployment. Some workers, particularly from railways companies are located in small towns or in regions of the country (for example, Southern and Eastern Serbia) where the prospects of finding new employment can be weak. Previous qualitative research of workers laid off from PA companies suggests that their best chances of reemployment would be in informal casual jobs.

4. **The rightsizing impacts are expected to have gender dimensions.** Workers are mostly female in Public Administration, especially in health (75 percent) and education (71 percent) where expected staff reductions are larger. In EPS and Railways, roughly 80 percent of the labor force are men.

Table 5.1 Welfare Characteristics Across Groups of Workers

	Electricity /1	Transport /2	Total non-SOE Public	Private Formal	Private Informal
Welfare characteristics					
Relative Poverty (<60% median income)					
Non-poor	98.9	89.5	96.7	88.3	52.7
Poor	1.1	10.5	3.3	11.7	47.4
Income Quintiles					
Lowest	1.1	4.6	1.9	8.6	39.1
2	5.8	17.2	8.6	16.1	26.8
3	10.1	25.3	14.6	22.3	17.6
4	24.6	22.4	26.4	26.1	10.6
Richest	58.4	30.5	48.5	26.8	5.9
Vulnerability Indicators					
Only adult employed in household	33.3	40.2	34.8	34.3	30.8
Only source of income	8.5	22.3	13.2	11.4	8.6
Bad health	5.4	7.7	4.9	3.8	13.3
Chronic illness	15.1	18.3	14.8	11.2	21.3
No one to talk problems	4.9	4.3	3.1	2.9	3.2
No friends or relatives to help	16.3	12.9	9.3	9.9	11.8
Pays rent	13.2	10.8	14.8	12.4	3.1

Source: World Bank staff elaboration based on 2013 Survey on Income and Living Conditions.
Notes: 1/ Electricity refers to public workers in the electricity, gas, steam and air-conditioning supply industry. 2/ Transport refers to public workers in the railways, road and pipeline transportation industry. Analyses available in Cancho and Nguyen (2016) show that Electricity and Transport categories capture to a large extent the characteristics of EPS and Railways Companies workers and hence can act as proxies for workers from those companies for the analysis. Non-SOE Public sector workers include public workers on the Public Administration, Health, Education, and Other Services (for example, financial, professional). Private formal and informal refers to registered and unregistered companies, as defined in the SILC.

Poverty and Social Impacts of Higher Electricity Costs and Protection of Vulnerable Customers

5. **The 2017 increase in household (guaranteed supply) electricity tariffs by 2 percent nominal (or zero percent in real terms) is expected to have a very limited adverse impact**. The tariff increase supported by PA5 of this DPL corresponded to only the rate of inflation and was not expected to have significantly affected purchasing power to the extent that nominal income also increased. Even a 2-percent price increase without income increase is simulated to have an impact of less than 0.1 percentage point on the poverty rate and on the share of electricity spending in total household budget.

6. **Even though the 2017 increase itself was small, energy affordability is still a concern for many poor households in Serbia.** Based on the EU Survey on Income and Living Conditions (SILC), almost one in five households in Serbia report that they cannot keep their home adequately warm; a share higher than in most of the new EU member countries. The rate is particularly high, 65.6 percent, among households in the bottom income quintile. Arrears and late payments of bills are common: 45.8 percent of lowest income households in Serbia have incurred at least one late payment in utility services, compared to only 14.7 percent in the top quintile. The poor and the elderly living alone spend more of their budget on electricity than other household categories, making them more vulnerable to increases in

electricity tariffs. The poorest quintile spends 8.9 percent of their total expenditures on electricity while the top quintile spends less than 5 percent. The elderly living alone, while often not among the poorest, tend to pay large heating and lighting expenses for their apartments out of their pension income. Single elderly households spend 14.9 percent of expenditure on energy and 8.6 percent on electricity, significantly higher than the average. Earlier electricity tariff increases in 2015 and 2016, a cumulative price increase of 16 percent, were expected to have increased electricity poverty (spending more than 10 percent of household budget on electricity) and the poverty headcount (using an anchored relative poverty line of 60 percent of median household income) from 15.0 percent to 16.0 percent.

7. **As part of Prior Action 4, the DPL also supports the government's continued efforts to protect vulnerable households against high energy expenditures through the existing energy bill discount program.** Following the implementation of the first tariff increase in August 2015, an inter-ministerial working group, chaired by the Ministry of Mining and Energy, was established to develop a new Decree on Energy Vulnerable Customers. With the objective of expanding coverage of vulnerable households, the amended decree, approved on December 31, 2015, eased some of eligibility criteria and removed another obstacle to take up. However, as an unintended consequence of a legal challenge to the earlier Decree, local self-governments became the only implementing agency for the benefit, making it more complicated for FSA (poverty-targeted social assistance) and child allowance (CA) beneficiaries to obtain the status of vulnerable customers in 2016. Following a sharp drop in the number of beneficiaries in early 2016 (from 58,000 households in December 2015 to 4,500 households in January 2016), the government made efforts to enhance administrative guidance to support local self-governments as the implementing authorities. It also relaxed the asset criteria in 2017 to increase eligibility for rural elderly people. The inter-ministerial working group, which was established in 2015 to develop a new Decree on Energy Vulnerable Customers, has continued to convene to monitor the program implementation and discuss options for improvement. The program will maintain the same design and implementation arrangements in 2018. With a similar allocated budget as in 2017, the program is estimated to maintain its coverage of around 70,000 households.

8. **Electricity prices increases will have gender dimensions.** 31.9 percent of households are headed by a female. In addition, female-headed households spent a much larger share of expenditure on energy (13.2 percent) than male-headed households (11.3 percent). The share of electricity is also higher among female-headed HH (7.2 percent vs. 6.6 percent). Finally, the incidence of electricity poverty in this group is higher than among male-headed households (21.1 percent vs. 16 percent), making them more vulnerable to electricity price increases. Maintaining protection through the energy bill discount program is important to cushion the impacts, including for female-headed households.

ANNEX 6: SUMMARY OF CHANGES COMPARED TO PEPU DPL1[68]

Prior actions and Triggers		Results	
Triggers for DPO2 in DPL1	**PAs DPL2**	**DPL1**	**DPL2**
(Indicative) Trigger #1. The Borrower, through its Ministry of Finance (a) puts in place a central register of invoices for public-public transaction and (b) enforces payment deadlines for said transactions.	*The Borrower has:* *(a) issued the Decree on Work and Role of Budget Inspection, to strengthen the budget inspection supervision and enforcement function;* *(b) adopted the PIFC Strategy and its associated action plan, to provide a framework for planned future developments of financial management and control and internal audit functions; and* *(c) through its Ministry of Finance, amended the Rulebook on the Budget Execution System, in order to ensure that accurate, complete and up-to-date information on budget commitments are available at the time when budget commitments are incurred.*	Results Indicator A1 – Increased percentage of invoices for public to public commercial transactions recorded in the central register: • Baseline (end-2015): 0 percent • Target (end-2018): 100 percent	Results Indicator A1. *Share of executed payments for public to public commercial transactions which were beforehand duly registered as commitments within deadlines prescribed by legislation:* • *Baseline (end-2015): 60 percent* • *Target (end-2018): at least 90 percent*
(Indicative) Trigger #2. Based on the Law on the Ceiling on Public Sector Employees, the Borrower has in 2017 set out updated institution-level limits on employees in the public sector, as determined by the Law.	Prior Action #2. The Borrower has updated institution-level limits on employees in the public sector for calendar year 2017.	Results Indicator A2 - The number of employees in the public sector, as determined by the Law on the Ceiling on Public Sector Employees, does not exceed the total of institutional-level limits set under the Law and its decisions: • Baseline (end-2015): no • Target (end-2018): yes	Results Indicator A2. The number of employees in the public sector, as determined by the Law on the Ceiling on Public Sector Employees, does not exceed the total of institutional-level limits set under the Law and its decisions: • Baseline (end-2015): no • Target (end-2018): yes

[68] Significant changes are marked in *italics*.

Prior actions and Triggers		Results	
Triggers for DPO2 in DPL1	**PAs DPL2**	**DPL1**	**DPL2**
(Indicative) Trigger #3. The Borrower, through its government, maps all employees within the education, health and social protection sectors to the new grades set out in the Public Sector Job Catalogue.	*Prior Action #3. The Borrower has:* *(a) amended the Law on Public Sector Employees Salary System;* *(b) enacted the Law on Employees in Public Services; and* *(c) enacted the Law on Salaries of Employees in Bodies of Local Sub-Government Units and Provincial Authorities, all with the objective to provide the legal framework for the mapping of positions between the Public Sector Jobs Catalogue and the new pay grades set forth in the Law on Public Sector Employees Salary System.*	Results Indicator A3 - Increased share of employees within the education, health and social protection sectors paid on the basis of their new grades set out in the Public Sector Job Catalogue: • Baseline (end-2015): zero • Target (end-2018): 60 percent	Results Indicator A3. *Increased share of positions within the education, health and social protection sectors mapped to new grades:* • *Baseline (end-2015): zero* • *Target (end-2018): 75 percent*
(Indicative) Trigger #4. The Borrower: (a) through the Council of the Energy Agency, approves an additional increase of the electricity tariff for guaranteed supply in 2017; and (b) takes measures, if necessary, to protect vulnerable households.	Prior Action #4. The Borrower, through the Council of the Energy Agency, has approved an increase of the electricity tariff for guaranteed electricity supply in calendar year 2017 and continued to protect vulnerable households from such electricity tariff increase by increasing the number of beneficiaries of the Energy Vulnerable Customers Program in calendar year 2017 compared to calendar year 2016.	Results Indicator B1 - Increased convergence of the guaranteed electricity supply tariff to reach market parity levels: • Baseline (end-2014): 64 percent • Target (end-2018): 80 percent Results Indicator B2 - Increased number of total beneficiaries of the Energy Vulnerable Program: • Baseline (2014 annual): 60,600 households; of which 27 percent female headed households • Target (2018 annual): 90,000 households; of which 30 percent female headed households	Results Indicator B1. Increased convergence of the guaranteed electricity supply tariff to reach market parity levels: • Baseline (end-2014): 64 percent • Target (end-2018): 80 percent[69] Results Indicator B2. Increased number of total beneficiaries of the Energy Vulnerable Program: • Baseline (2014 annual): 60,600 households; of which 27 percent female headed households • *Target (2018 annual): 70,000 households; of which 30 percent female headed households*

[69] See paragraph 49 in Section 4.1 of this Program Document for further detail.

Prior actions and Triggers		Results	
Triggers for DPO2 in DPL1	**PAs DPL2**	**DPL1**	**DPL2**
(Indicative) Trigger #5. The Borrower, through the Supervisory Board of EPS, implements the labor rightsizing in 2016 and 2017 in accordance with the EPS Labor Optimization Plan.	Prior Action #5. The Borrower, through the Supervisory Board of Elektroprivreda Srbije (EPS) has: (a) updated the labor optimization plan for calendar year 2017, including annual targets, compensation packages, eligible categories, selection criteria, and grievance mechanisms for EPS; and (b) issued the second call for voluntary separations.	Results Indicator B3 - Reduction in annual EPS wage bill relative to 2014: • Baseline (2015): zero • Target (2018): 10 percent	Results Indicator B3. *Increase in the share of the EPS workforce with education above secondary-level relative to 2015:* • *Baseline (2015): zero* • *Target (2018): 5 percent* •
(Indicative) Trigger #6. The Borrower improves *Srbijagas* financial management through: (a) implementation of the policy for gas supply interruption based on the government adoption of a conclusion defining the mechanisms to discontinue gas supplies to commercial consumers in arrears; (b) the Ministry of Energy and Mining issues an opinion on an investment appraisal methodology as adopted by the management of Srbijagas; and, (c) the *Srbijagas* audit committee documents its activities as the body in charge of the oversight of the system of internal controls, internal audit, and external audit.	Prior Action #6. The Borrower, through Srbijagas, has strengthened Srbijagas' financial management through: (a) the adoption of the Government Conclusion, which defined the mechanisms to discontinue gas supplies to commercial consumers in arrears; (b) the approval by Srbijagas management of Decision, which adopted a company-specific appraisal methodology for investments; and (c) the approval by Srbijagas management of Decision, which established Srbijagas' audit committee as the body in charge of the oversight of Srbijagas' system of internal controls.	Results Indicator B4 - Increase in *Srbijagas*' collection rate of current receivables: • Baseline (2015): 80 percent • Target (average 2016-2018): 87 percent Results Indicator B5 - The approved *Srbijagas* 10-year development plan for the Gas Transport System Operator and 5-year development plan for the Distribution System Operator are in accordance with the adopted economic and financial appraisal methodology: • Baseline (2016): No • Target (2018): Yes	Results Indicator B4. Increase in *Srbijagas*' collection rate of current receivables: • Baseline (2015): 80 percent • Target (average 2016-2018): 87 percent Results Indicator B5 - The approved *Srbijagas* 10-year development plan for the Gas Transport System Operator and 5-year development plan for the Distribution System Operator are in accordance with the adopted economic and financial appraisal methodology: • Baseline (2016): No • Target (2018): Yes •

Prior actions and Triggers		Results	
Triggers for DPO2 in DPL1	**PAs DPL2**	**DPL1**	**DPL2**
(Indicative) Trigger #7. The Borrower: (a) through the respective railways operating companies, approves and initiates the implementation of a plan to restructure their commercial debt in a manner that places the companies in a position to be financially viable; and (b) through the management of the respective railway companies, makes publicly available the annual financial statements of the new railways companies prepared under IFRS, as required under the Law on Accounting, and modernizes their financial and accounting systems to allow effective implementation of IFRS.	Prior Action #7. The Borrower, through: (a) each Railways Company has settled its debt with EPS and issued a plan to restructure its commercial debt in a manner that places the company in a position to be financially viable and started its implementation; (b) each Railways Company made publicly available its Annual Financial Statements for calendar year 2016; and (c) through each Railways Operating Company has allocated resources for the upgrade of its financial and accounting system to allow an effective financial management of the company and application of International Financial Reporting Standards.	Results Indicator C1 - Level of annual direct budget operational support to the Railways Companies: • Baseline (2015): RSD 13.5 billion • Target (2018): RSD 11 billion Indicator C2 - Improvements in labor productivity (measured by train kilometers per employee) and in asset utilization (measured by passengers per kilometer of track and ton per kilometer of track) relative to 2014: • Baseline (2015): zero • Target (2018): 15 percent (for both indicators)	Results Indicator C1. Level of annual direct budget operational support to the Railways Companies: • Baseline (2015): RSD 13.5 billion • Target (2018): RSD 11 billion Results Indicator C2. Improvements in labor productivity (measured by train kilometers per employee) and in asset utilization (measured by passengers per kilometer of track and ton per kilometer of track) relative to 2014: • Baseline (2015): zero • Target (2018): 15 percent (for both indicators)
(Indicative) Trigger #8. The Borrower, through the General Assemblies of the respective railways companies, implements labor rightsizing in 2016 and in 2017 in accordance with their respective Labor Optimization Plans.	Prior Action #8. The Borrower, through each Railway Company has: (a) updated its labor optimization plan for calendar year 2017, including the annual targets, eligibility criteria, compensation packages, and grievance mechanisms; and (b) achieved the targets for calendar year 2017 set forth in said labor optimization plan.	Results Indicator C3 - Reduction in annual wage bill of railways companies relative to 2015: • Baseline (2015): zero • Target (2018): 25 percent	Results Indicator C3. Reduction in annual wage bill of railways companies relative to 2015: • Baseline (2015): zero • Target (2018): 25 percent

Prior actions and Triggers		Results	
Triggers for DPO2 in DPL1	**PAs DPL2**	**DPL1**	**DPL2**
(Indicative) Trigger #9. The Borrower, through its government, prepares a framework service-level agreement with PERS defining standards for different road classes, committing to provide the agreed financing for roads and holding PERS accountable for service delivery.	Prior Action #9. The Borrower, through PERS, has prepared and approved a framework for a service-level agreement to be entered with MCTI, for purposes of: (a) defining the performance standards for different road classes, based on pavement conditions, operational standards, and safety; (b) require the Borrower, through MCTI to provide an agreed financing for roads to achieve the agreed performance standards; and (c) holding PERS accountable for agreed performance standards.	Results Indicator C4 - The government agrees with Roads of Serbia on maintenance levels for the different road classes with associated guaranteed funding levels committed: • Baseline (for 2016 budget): no • Target (for 2019 budget): yes	Results Indicator C4. The government agrees with Roads of Serbia on performance levels for the different road classes with associated guaranteed funding levels committed: • Baseline (for 2016 budget): no • Target (for 2019 budget): yes