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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED DEVELOPMENT POLICY LOAN
IN THE AMOUNT OF EUR 88.3 MILLION
(US$100 MILLION EQUIVALENT)

TO

THE REPUBLIC OF SERBIA

FOR A

FIRST PROGRAMMATIC STATE OWNED ENTERPRISES REFORM DEVELOPMENT POLICY LOAN

February 26, 2015

Trade and Competitiveness Global Practice (GTCDR)
South East Europe Country Unit (ECCU4)
Europe and Central Asia (ECA)

REPUBLIC OF SERBIA - GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Official Exchange Rate Effective as of February 4, 2015)

Currency Unit	Serbian Dinar
RSD 1.00	US$0.009
US$1.00	RSD 106.00

Metric System

ABBREVIATION AND ACRONYMS

ALMP	Active Labor Market Programs
BOP	Balance of Payments
CAD	Current Account Deficit
CPS	Country Partnership Strategy
CSP	Country Strategy Paper
DIA	Deposit Insurance Agency
DPL	Development Policy Loan
EC	European Commission
ECA	Europe and Central Asia
ELD	Environmental Liability Directive
EPS	Elektroprivreda Srbije (Serbia's national electric power utility)
EU	European Union
EUR	Euro
FDI	Foreign Direct Investments
FSC	Financial Stability Committee
FX	Foreign Exchange
FY	World Bank Fiscal Year
GDP	Gross Domestic Product
GoS	Government of Serbia
HBS	Household Budget Survey
IBNet	International Benchmarking Network of water and sanitation utilities
IBRD	International Bank for Reconstruction and Development
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPPC	Integrated Pollution Prevention And Control
JSC	Joint Stock Company
KPIs	Key performance indicators
LDP	Letter of Development Policy
LEP	The Law on Environmental Protection
LFS	Labor Force Survey
LLCs	Limited Liability Companies
MoE	Ministry of Economy
MoF	Ministry of Finance
MoJ	Ministry of Justice
MoLEVSA	Ministry of Labor, Employment, Veterans, and Social Affairs
NBS	National Bank of Serbia

NEAP	National Employment Action Plan
NES	National Employment Service
NIS	Naftna Industrija Srbije (State Oil Company)
NPLs	Nonperforming loans
OECD	Organization for Economic Cooperation and Development
PA	Privatization Agency
PDO	Program Development Objective
PE	Public Enterprises
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PFMA	Public Financial Management Assessment
PIFC	Public Internal Financial Control
PSIA	Poverty and Social Impact Assessment
PUCs	Public Utility Companies
RoS	Republic of Serbia
RSD	Serbian Dinar
SAA	Stability and Association Agreement
SAI	State Audit Institution
SMEs	Small and medium enterprises
SOE	State-Owned Enterprise
TA	Technical Assistance
US$	United States Dollar
VAT	Value Added Tax

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REPUBLIC OF SERBIA
FIRST PROGRAMMATIC STATE OWNED ENTERPRISES REFORM
DEVELOPMENT POLICY LOAN

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LOAN AND PROGRAM SUMMARY
FIRST PROGRAMMATIC STATE OWNED ENTERPRISE REFORM
DEVELOPMENT POLICY LOAN (DPL)

Borrower	Republic of Serbia
Implementing Agency	The Ministry of Finance (MoF) and the Ministry of Economy (MoE) of the Republic of Serbia will be responsible for overall implementation of the proposed operation. Other key ministries and agencies involved in the operation will include: the Ministry of Labor, Employment, Veteran and Social Affairs, and the Privatization Agency (PA).
Financing Data	IBRD Loan Terms: IBRD Flexible Loan at 6 month LIBOR for Euro with variable spread, with a 20 year maturity and 8 years of grace period. Amount: EUR 88.3million (US$100 million equivalent).
Operation Type	The proposed First Programmatic State Owned Enterprises (SOEs) Reform Development Policy Loan is the first in a series of two programmatic Development Policy Loans (DPLs) designed to support Republic of Serbia reform program of the state owned enterprise sector.
Pillars of the Operation And Program Development Objective(s)	The Program Development Objectives (PDOs) are to reduce state participation and level of direct and indirect support to the real sector, enhance SOE performance, governance and accountability, and mitigate the short term social and labor impacts of the SOEs restructuring and disposition plans. These objectives will be achieved through supporting reforms carried out by the Government of Serbia, revolving around three policy areas: <u>Pillar A:</u> Accelerating the restructuring and divestiture program for the Privatization Agency portfolio and selected state owned enterprises operating in the commercial sector. <u>Pillar B:</u> Strengthening governance regulatory framework and institutional framework, and monitoring and transparency arrangements for state owned enterprises. <u>Pillar C:</u> Mitigating the Social and Labor Market Impact of the state owned enterprises reform program.
Results Indicators	**Result Indicator A1**—Reduction of direct and indirect support to companies in the Privatization Agency portfolio: - Annual direct subsidies and soft loans (million Euro): o Baseline (average 2010-2012): 85; Target (2015): less than 10 - New taxes and social contribution arrears: o Baseline (average 2010-2012): 190; Target (2016): less than 20 - New arrears to public utilities: o Baseline (average 2010-2012): 70; Target (2016): less than 20

	Result Indicator B1—Audited financial statements prepared and published by enterprises in accordance with provisions of Law on PE and new Laws on Accounting and Auditing for Public Enterprises for which the founder is the Republic of Serbia: Baseline (2012, none); Target (2015), all 24). **Result Indicator B2—**Reduction of direct subsidies and issuance of new guarantees for liquidity purposes for large SOEs: - Direct subsidies (million Euro) o Baseline (average 2010-12): 250; Target (2015): less than 200 - Annual guaranties for liquidity purposes (million Euro): o Baseline (average 2012-2014): 265; Target (2015): less than 100 **Result Indicator C1—** Number of redundant workers receiving compensation from the Transition Fund increases from approx. 5,700 (2014) to at least 10,000 (2015) (to be monitored by gender). **Result Indicator C2—** At least 30 percent of workers made redundant from public enterprises during 2015 register with NES (to be monitored by gender). **Result Indicator C3—**Number of participants in public works increases from 2,882 in 2013 (1,187 female and 1,695 male) to at least 6,000 in 2015 (to be monitored by gender).
Risks and Risk Mitigation	**Overall risk rating for this operation is high.** There is a broad consensus that the supported reforms are needed and overdue, albeit these will undermine entrenched interests in the short run while the expected benefits will be delayed and more diffused. Rising social and political pressures could prompt a slowdown of the reforms, jeopardizing the PDOs of the series. The overall and political risks are mitigated by Government's strong commitment to tackle the situation in the SOE sector. The overarching strategic objective and aspiration of Serbia to furthering economic integration with the European Union which calls for an acceleration of the structural reforms, should also contribute to diffuse political resistance. The series includes a pillar specifically dedicated to mitigate the social and employment impact of the program. The Bank will also support the authorities in communicating the benefits of the proposed reforms to preserve political momentum for the reform program. **There are substantial external and internal macroeconomic risks.** External risks are related to slower economic recovery in Europe, which could have a negative impact on exports, remittances and capital flows and hamper Serbia's growth. Internal risks to the fiscal framework arise from: (i) the difficulty to circumscribe the issuance of new guarantees; and (ii) a failure to reduce subsidies as intended. There are also implementation risks relating to other key structural fiscal reform areas, such as right sizing of the public sector aimed at improving government

	efficiency. If some of these risks materialize, the government would need to make greater fiscal consolidation efforts in 2015 and 2016 to ensure that public debt remains sustainable. To mitigate these risks the Bank is working closely with the government and the IMF to ensure that the reform of state owned enterprises and public utilities remains on track and that it generates the anticipated fiscal savings. These risks are further mitigated by WBG comprehensive engagement in Serbia, including on public sector reform. **Implementation risks are substantial.** The proposed program will strain the capacity of public sector institutions directly involved in implementation. These risks will be mitigated by various ongoing or completed technical assistance programs: technical assistance provided in the context of the mid-term review of Serbia's Employment Strategy; IFC TA on insolvency and debt resolution; the Road to Europe: Program for Accounting Reform and Institutional Strengthening (REPARIS) program supporting financial reporting and audit reforms; follow up TA on corporate accounting and audit provided by CFRR. The risks will be further mitigated by a separate results based loan on Competitiveness and Jobs, which is under preparation and includes a specific component on strengthening the capacity of the National Employment Service, and reforming the design of Active Labor Market Programs (ALMPs). **Financial management risk to Bank development policy lending funds is substantial and environmental risk is moderate.** The FM risk is based on country financial management risk, not related to stand alone assessment of this operation only. The country financial management risk is mitigated by the fact that the most reliable parts of the PFM system are used for implementation of the DPL (i.e. Treasury and NBS). The assessments of PFM performance acknowledges progress from ongoing reforms and identifies areas needing further strengthening, including with respect to transparency, accountability and control framework to mitigate the fiduciary risks associated with the PFM system in Serbia. A number of progressive steps were taken to address environmental liabilities of entities undergoing privatization. However, in practice these measures have not been applied consistently and their impact has been mixed. Certain risks were also identified regarding the capacity of the Privatization Agency to coordinate with Ministries of Finance, and Economy, and Energy Development and Environmental Protection to implement a program for addressing environmental legacies in state own enterprises slated for privatization. The authorities confirmed that the environmental assessment for the companies in restructuring will be updated as required before their disposition. Similarly, coordination and implementation mechanisms to follow-up action plans and post-privatization compliance reports will be strengthened.
Operation ID	P127408

PROGRAM DOCUMENT FOR A
PROPOSED FIRST PROGRAMMATIC STATE OWNED ENTERPRISES REFORM DEVELOPMENT POLICY LOAN TO THE REPUBLIC OF SERBIA

I. INTRODUCTION AND COUNTRY CONTEXT

1. **This program document presents a proposed first State Owned Enterprise Reform Development Policy Loan (DPL) to the Republic of Serbia for an amount of EUR 88.3 million (US$100 million equivalent) for the period FY15-FY16.** This is the first loan in a programmatic series of two operations supporting Government of Serbia's structural reform program for the state owned enterprises (SOE) sector, which aims at reducing state participation and level of direct and indirect support to the real sector, enhancing SOE performance, governance and accountability, and mitigate the short term social and labor impacts of the SOE restructuring and disposition plans. The measures supported under the proposed series are an integral part of the Government of Serbia's (GoS) economic and development strategy. The proposed series is fully congruent with Country Partnership Strategy and contributes to both of the pillars of the FY12-15 CPS (Pillar 1: the "Strengthening competitiveness" and Pillar 2: "Improved Efficiency and Outcomes in Social Spending"), supporting economic growth by tackling the bottlenecks to improved productivity and competitiveness, and supporting reforms to some of the key aspects of the social safety net system.

2. **The economic crisis has exposed structural weaknesses in Serbia's economic growth model, and prompted the need for fiscal consolidation and the acceleration of the unfinished transition to market economy.** The rapid growth experienced by Serbia during 2004–08 was driven mainly by domestic consumption and resulted in significant internal and external imbalances, which proved all but sustainable. The crisis unearthed remaining key structural weaknesses and obstacles that hamper sustainable economic development, including a pervasive influence of the state on the economy and unfavorable business environment with cumbersome administrative procedures. The sluggish economic performance since the onset of the global financial crisis was accompanied by a deterioration of Serbia's fiscal stance and a rapid increase of public debt, which doubled since 2009 to reach over 70 percent of GDP in 2014. Similarly, the stock of public guarantees, issued mainly to State-owned Enterprises, increased from less than 3 percent of GDP in 2008 to over 6 percent at end-2014.

3. **The crisis also resulted in a deterioration of the living conditions in Serbia with poverty and unemployment rising steadily since 2008.** In 2010 (the last year for which official poverty data have been released) poverty reached 9.2 percent (from 6.1 percent in 2008). Between 2009 and 2010 poverty increases have been concentrated in rural areas, albeit detailed analysis reveals that urban areas have seen large increases in the group of households between 100 and 150 percent of the poverty line, raising concerns on the effects of further shocks to the urban economy. Staff estimates using a micro-simulation model suggest that by 2011 poverty might have climbed to over 11 percent.[1] Despite recent improvements due to increased employment in the informal sector, unemployment remains high and was estimated at 16.8 percent (17.3 for women and 16.4 percent for men) in the fourth quarter of 2014 for individuals of age 15 and over (decreasing from

[1] A more detailed update in these trends is provided by World Bank "Western Balkans Programmatic Poverty Update - Poverty Update for the Republic of Serbia", in process.

20.1 a year earlier). As a result currently, the employment rate stands at only 40.4 percent (33.6 for women and 47.6 for men).

4. **The combination of economic pressures, an improvement in relations with Serbia's neighbors and domestic reform momentum, provide an important opportunity to accelerate reforms.** The March 2014 elections have given Serbia an opportunity to build a new momentum for reform. The elections resulted in the Serbian Progressive Party (SNS) winning 48.4 percent of votes and absolute majority of 158 seats out of the total 250 seats assembly. The new government has committed to focus on transforming the state administration, public finances and economy, along with pursuing the EU accession process. The economic program for 2015-2017 will focus on ensuring economic and financial stability, stopping further debt accumulation and creating an environment for economic recovery and growth to foster employment and raise living standards. These goals will be achieved primarily through fiscal consolidation measures and an acceleration of structural reforms to remove existing bottlenecks to economic growth, including the reform of state-owned enterprises.

5. **The reform of state-owned enterprises is critical to the success of GoS's economic program, contributing to medium term fiscal consolidation efforts, as well as economic recovery through improved economic efficiency.** Despite significant achievements in the early years of the transition to a market economy – with over 2,700 enterprises privatized – the role of the State in the enterprise sector remains pervasive with about 1,200 state-owned enterprises (SOEs), employing more than 250,000 people. While this is a very heterogeneous group of enterprises, overall they perform poorly, have weak governance mechanisms, and remain prone to political interferences. To stay afloat, many public sector enterprises receive significant direct budget subsidies and soft loans, as well as indirect support in various forms, including unpaid taxes and contributions, state guarantees for loans, arrears to other state entities and public utilities.

6. **This series of Development Policy Operations supports the Government's economic program and focuses on the structural reforms related to the state owned enterprises sector.** The development objectives of the series are to reduce state participation and level of direct and indirect support to the real sector, enhance SOE performance, governance and accountability, and mitigate the short term social and labor impacts of the SOE restructuring and disposition plans. This sector has now reached a critical stage of reform with a clear path for an orderly restructuring. This operation supports a number of specific measures in the following three pillars: (i) completion of restructuring and divestiture program to reduce the direct and indirect state support to companies in the Privatization Agency portfolio and state owned enterprises operating in the commercial sector; (ii) strengthening governance regulatory framework, institutional arrangements, and monitoring and transparency arrangements for improved performance and accountability of state owned enterprises; and (iii) mitigating the Social and Labor Market Impact of the reform program.

7. **The overall risk of the proposed series is high.** While there is a wide consensus that the supported reforms are needed and long overdue, they are likely to face significant social and political pressures which could slow down or derail their implementation. These risks are mitigated by the overarching strategic objective and aspiration of Serbia to furthering economic integration with the European Union which calls for an acceleration of the structural reforms. The design of the series also includes a pillar dedicated to mitigating the social and employment impact of the

program. The Bank will also support the authorities in communicating the benefits of the proposed reforms to preserve political momentum for the reform program.

II. MACROECONOMIC POLICY FRAMEWORK

A. RECENT ECONOMIC DEVELOPMENTS

8. **Serbia's economic performance has remained sluggish since the global financial crisis of 2008 and fell back into recession in 2014, for the third time in five years.** The economy contracted by 3.5 percent in 2009 and, after a timid recovery in 2010 and 2011, again fell back into recession in 2012. A rebound in 2013 was followed by a projected contraction of 2.0 percent in 2014.[2] As a result, the level of real GDP in 2014 remained 1.9 percentage points below its 2008 value. While the 2009 recession was mainly due to the severe impact of the international economic crisis, recessions in 2012 and 2014 were primarily caused by natural disasters – a drought in 2012 and severe floods in 2014. In addition, weak domestic demand and various structural bottlenecks prevented the economy from recovering more rapidly. Elections and changes in the government also delayed the implementation of reforms, and thus contributed to the weakness in activity.

9. **The economy has tipped into recession in 2014 primarily as a result of the May 2014 floods.**[3] Weak domestic demand and broad-based falls in private and government consumption along with private investment contributed almost all of the projected contraction in activity in 2014. Although exports still contributed positively to growth, their weakening performance was offset by imports, resulting in a zero net contribution of external demand to growth. On the production side, the energy sector was hit the hardest with two major coal mines that serve as a source of lignite for thermal plants flooded. The 2014 recession has been wide-spread, affecting all sectors except agriculture and telecommunication services. Energy output was 17.4 percent lower in 2014 than in 2013, while manufacturing output was 1.4 percent lower and construction 4.1 percent lower over the same period. Services decreased by 0.7 percent in the first three quarters of 2014 compared to the same period 2013.

10. **Export growth has slowed, dampening GDP growth performance.** Since 2010, and in particular in 2013 when the carmaker FIAT started production in Serbia, exports were a significant driver of growth. However, in 2014, exports began slowing down, dampening GDP growth since the third quarter. The export slowdown was mainly due to lower energy sector production; lower foreign demand and sales volumes of FIAT; and a decrease in output in state-owned enterprises awaiting privatization (like Petrohemija). Stronger economic recovery continues to be hampered by weak domestic demand which has declined for three consecutive quarters in 2014.

11. **Despite recent improvements, unemployment rates remain high, particularly among the youth.** The unemployment rate decreased to 16.8 percent in the fourth quarter 2014, from 20.1 percent two years earlier.[4] However, the large majority of the jobs that have been created since 2012 were part-time and/or in the informal sector. The number of formal full-time jobs

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2 The end-January 2015 "flash" release of Q4 GDP 2014 growth was -1.6 percent, slightly higher than projected and moving 2014 growth to an estimated -1.7 percent versus the prior estimate outlined in Table 1 of -2.0 percent. Awaiting the full GDP release at end-February 2014, the preceding estimates for 2014 are referenced in this section.

3 The floods are estimated to have caused around euro 864 million in damages and euro 648 million in losses. This translates into, respectively, 2.7 percent of GDP in damages and 2 percent of GDP in losses in 2014.

4 Unemployment figure refers to 15 year and older population (Source Statistics Office Labor Force Survey).

created actually decreased over this period. Currently, 17.7 percent of all jobs in Serbia are informal, an increase of around 2 percentage points compared to 2013. Within the informal sector, most of the new jobs were created in agriculture, but also in construction and services. Youth unemployment dropped to 42 percent but remains still very high. Many young people are leaving the country in search of employment opportunities, in particular in Western Europe. As growth (or lack of it) tends to translate into labor market performance with a time lag, the 2014 recession does not bode well for Serbia's labor market performance in the immediate future.

12. **Having fluctuated markedly in recent years, inflation remained subdued throughout 2014.** Since March 2014 inflation rate average has remained around 2 percent (y-o-y), remaining well below the lower bound inflation target of 4±1.5 percent). Lower inflation in 2014 was primarily the result of low food prices (in the first half of the year) and the absence of adjustment of administratively controlled prices in the second half of the year. Core inflation averaged 0.4 percent in 2014.

13. **The real exchange rate has also been relatively volatile with the nominal and real exchange rates also steadily depreciating during 2014.** The dinar depreciated in nominal terms by 5.2 percent against the euro since the beginning of the year, with pressure on exchange rate growing in the second half of the year and early 2015 (with the dinar down a further 1.4 percent in 2015 through 21 January). The real effective exchange rate also depreciated, by about 6 percent through December 2014. The National Bank of Serbia's inflation targeting framework and commitment to maintain a flexible exchange rate are deemed appropriate, albeit reducing inflation volatility remains a challenge due to significant exchange rate pass-through, high levels of euroization which limits the monetary transmission mechanism, and fiscal policy.

14. **The financial system is broadly stable, although weaknesses remain in some state-owned banks.** The Serbian financial system weathered the global financial crisis of 2008/2009 relatively well, but a weak economic recovery, and significant depreciation resulted in a substantial increase in nonperforming loans (NPLs) (which stood at 23 percent as of September 2014), deterioration in asset quality and reduction in profitability. While the banking system remains well-capitalized and liquid, difficulties have emerged, particularly among domestically-owned banks - four of which have been liquidated and required government's intervention since 2011. The Government, with the financial and technical support from the World Bank and the EBRD has undertaken substantive reforms to strengthen the bank resolution and deposit insurance systems. The recent appreciation of the Swiss franc will put further strain on the banking sector, since around 13 percent of total credit to households is linked to the Swiss franc (mainly mortgage loans). Credit to private enterprises declined between September 2012 and May 2014 and then recovered in the second half of 2014, primarily due to the introduction of subsidized loans in June. These recent events call for further strengthening of the financial stability framework including the operationalization of the Financial Stability Committee (FSC) and the Deposit Insurance Agency (DIA). The Bank is currently assisting the authorities with a recapitalization of the DIA.

15. **The fiscal deficit in 2014 is projected to remain high, at 7.5 percent of GDP (including amortization of called guarantees)**. Expenditures have continued to increase (e.g. spending on goods and subsidies were higher in 2014 by 7.2 and 15.6 percent year-on-year), picking up by 3.3 percentage points of GDP relative to 2013, and offsetting a recovery in revenue-to-GDP ratio. The fiscal performance in 2014 is a continuation of the deterioration in Serbia's consolidated general government fiscal balance since 2008. Revenues fell over 2008-11, but have since recovered in part due to increases in the VAT rate (Table 1). Expenditures on the other hand have grown steadily

since the crisis. The result has been a steadily deteriorating general government fiscal deficit from around 2.6 percent of GDP in 2008 to about 7.2 percent of GDP in 2012, which subsequently subsided to 5.6 percent in 2013. The decline in fiscal deficit in 2013 was primarily due to cuts in capital expenditures and subsidies, and introduction of new rules for the indexation of salaries and pensions in the public sector, which lowered the wage bill and spending on pensions.

16. **Reflecting the deteriorating fiscal balances, Serbia's public debt, including guarantees, has more than doubled since the global crisis, from 32.4 percent of GDP in 2008 to over 70 percent at end-2014.** Guarantees, issued principally to SOEs, grew rapidly from 2.8 percent of GDP in 2008 to 8.3 percent of GDP at end-2013, and dropped somewhat in 2014 to 7.7 percent of GDP in December. Domestic public debt grew from around 10 percent of GDP in 2008 to about 27 percent of GDP in December 2014, while external public debt grew from around 17 percent of GDP in 2008 to 41.7 percent of GDP in December 2014. The stock of public debt is expected to have reached around 72 percent of GDP by end-2014.

Table 1. Key Macroeconomic Indicators and Projections

	2010	2011	2012	2013	2014 [c]	2015[d]	2016[d]	2017[d]
Real Economy	Annual percentage change							
GDP (nominal--local currency)	6.5	11.1	5.2	8.1	0.1	2.2	5.6	6.2
Real GDP	1.0	1.6	-1.5	2.6	-2.0	-0.5	1.5	2.0
Contributions:								
Consumption	-0.4	0.9	-1.2	-0.6	-1.6	-3.6	-0.2	0.4
Investment	-1.3	2.6	0.6	-1.5	-0.4	0.9	1.1	1.1
Net Exports	2.3	-2.1	-0.4	3.8	0.0	2.2	0.6	0.5
Imports	2.0	3.8	0.7	3.6	1.5	-0.8	1.6	2.6
Exports	4.3	1.6	0.3	7.4	1.5	1.4	2.2	3.1
Unemployment rate (average, ILO definition)	19.2	23.0	24.0	22.1	18.9	19.0	18.0	17.0
GDP deflator	5.9	9.6	6.3	5.4	2.2	2.7	4.1	4.1
CPI (eop)	10.2	7.0	12.2	2.2	1.7	4.2	4.0	4.0
Fiscal Accounts	Percent of GDP							
Expenditures	44.6	43.1	46.6	43.5	46.8	44.6	42.4	40.7
Revenues	39.9	38.2	39.4	37.9	39.4	38.7	37.7	36.9
General Government Balance	-4.7	-4.9	-7.2	-5.6	-7.5	-5.9	-4.7	-3.8
Public and Publicly Guaranteed Debt (eop)[a]	43.7	46.6	56.9	60.5	72.5	78.1	79.6	79.3
Selected Monetary Accounts	Annual percentage change, unless otherwise indicated							
Base Money	-2.0	15.8	5.2	25.9				
Credit to non-government	26.9	7.7	9.8	-4.5				
Interest (key policy interest rate)	11.5	9.8	11.3	9.5	8.0			
Balance of Payments	Percent of GDP							
Current Account Balance [b]	-6.5	-8.6	-11.5	-6.1	-6.1	-4.7	-4.7	-4.4
Imports	-42.4	-43.2	-44.2	-42.9	-45.1	-45.0	-43.9	-43.9
Exports	24.8	25.2	26.5	30.8	32.5	33.9	33.6	34.3
Foreign Direct Investment	3.0	5.5	2.1	3.6	3.8	4.0	3.8	4.0
Gross Reserves (in US$ bill, eop)	13.3	15.6	14.4	15.4	12.0			
In months of next year's imports	8.3	10.2	8.9	9.4	7.2			
Terms of Trade	-0.6	3.5	-0.9	1.0	-0.1	-0.3	-0.2	0.1
Exchange Rate (average)	77.9	73.3	87.9	85.2	88.5			
Other memo items								
GDP nominal in US$ billion	39.4	46.5	40.7	45.5	43.6			

[a] World Bank projections including non-guaranteed debt of local governments.

[b] BoP data using BPM6 is available only as of 2012, for years 2010-11 the data are using the earlier BOP manual.

[c] Estimates.

[d] Projections.

Source: Ministry of Finance; World Bank estimates; International Monetary Fund; National Bank of Serbia.

B. Macroeconomic Outlook, Debt Sustainability And Risks

17. **Over the medium term, the Government's macroeconomic framework as defined in the recently adopted Fiscal Strategy 2015-17 and supported by an IMF program, projected GDP growth recovering to around 2 percent by 2017, supported by net exports and investment (Table 1)**. After a further contraction (of 0.5 percent of GDP) in 2015, activity is projected to pick up markedly in 2016 on the back of improved exports, sustained investment growth, and a full rebound from the impact of the floods in 2014. Domestic demand will remain weak due to declining private consumption and fiscal consolidation, but the decline in consumption is expected to decelerate over time, again with a notable improvement in 2016. The fiscal consolidation will cut current spending and simultaneously increase investment in order to stimulate economic growth and employment, while maintaining safety nets for the most vulnerable in the society. The rise in investment and export performance over the medium term build in the impact of the government's plans to: undertake structural reforms to streamline bureaucracy and create a stable and predictable business environment; restructure and privatize the remaining state-owned enterprises; and gradually reduce the state's share in the economy.

18. **The current account deficit is projected to narrow from 6 percent of GDP in 2014 to about 4.7 percent of GDP by 2016**, as exports grow faster than imports. Much of the adjustment takes place in 2015, in part due to an unwinding of the impact of the floods in 2014 which pushed up imports relative to the baseline (particularly for electricity, oil, gas reconstruction materials) and reduced exports (especially energy and, to a lesser extent, manufacturing). Nevertheless, the adjustment process of the current account through a sustained improvement in export performance is predicated on a pick-up in the growth of trading partner import demand, although there may be some additional support via imports from the downward movement in oil prices. FDI inflows, again supported by progress on structural reform measures, are projected to increase gradually, but remain of the order of 4 percent of GDP. These inflows are expected to provide the bulk of net financing of the current account deficit, although the basic balance will remain negative.

19. **Inflation is projected to pick up from around 2 percent in 2014 to 4 percent in 2015 and remain at that level through 2017, in line with the growth recovery.** 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 2015 and 2016 is set at 4 percent ±1.5 percentage points.

20. **In an effort to overcome its fiscal challenges, the government has adopted an ambitious fiscal consolidation and structural reforms program to halt the rise in public debt and put it on a downward trajectory by 2017.**[5] Over the medium-term, government spending will be reduced from 46.8 percent in 2014 to 40.7 percent of GDP by 2017, mostly through cutting recurrent spending.[6] The revenue-to-GDP ratio will decline slightly despite the projected positive economic growth, as exports and investments, the main drivers of growth, are not seen as helping revenues (e.g. through VAT) significantly.

[5] This is supported by an IMF 3-year Stand-By Arrangement approved on February 23, 2015.

[6] The Fiscal Strategy has slightly different figures for both revenues and expenditures since there was a change in the methodology used for reporting on gross wages and collected social contributions.

21. **The fiscal consolidation program will be pursued through a focus on reducing public sector wage bills and pension costs, along with a reduction in fiscal support to public enterprises**, in conjunction with broad-ranging structural reforms. The latter components of the program are focused on restructuring of large public enterprises, as supported in this operation, and improving the investment climate. The 2014 budget revision laid out the first steps in the government's fiscal consolidation program through across the board cuts in wages and pensions. These included: (i) no indexation of wages as of October (the legal obligation was an increase of 1 percent in April and October); and (ii) nominal reduction of wages in the public sector of 10 percent as of November 2014. In parallel the parliament approved the Law on Temporary Reduction of Pensions, also effective as of November 2014 which envisages reduction of pensions by 22 and 25 percent above the threshold of RSD 25,000 and RSD 40,000, respectively. Estimated savings from these measures were 3.5 percentage points of GDP over 2014 to 2016.

22. **The 2015 budget approved by the parliament in December 2014, targets a deficit reduction of two percentage points of GDP in 2015 relative to the projected 2014 outcome.** Around four-fifths of the adjustment is planned to come from higher revenues, primarily through non-tax revenues (whose treatment in the Budget has been amended but which are expected to come from higher share of profits of public enterprises being clawed back to the Budget, the introduction of duty for mandatory oil reserves and placement of funds from salary cuts in special accounts of non-tax revenues). Most of the relatively limited expenditure savings are to come from a lower wage bill and subsidies, offset by increases in spending on interest payments; social assistance and investments. Importantly though the 2015 budget sets out a policy of no longer issuing new guarantees to cover state owned enterprises losses.

Table 2: Consolidated General Government Fiscal Operations

(In percent of GDP)	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Revenue	**39.8**	**39.9**	**38.2**	**39.4**	**37.9**	**39.4**	**38.7**	**37.7**	**36.9**
Taxes	34.7	34.5	33.2	34.2	33.4	35.0	34.0	33.2	**32.5**
Personal income tax	4.6	4.5	4.4	4.6	4.0	3.7	3.6	3.4	**3.4**
Social security contributions	11.1	10.6	10.2	10.6	10.8	11.2	10.6	10.2	**10.0**
Corporate income tax	1.1	1.1	1.1	1.5	1.6	1.9	1.9	1.9	**1.9**
Value-added taxes	10.3	10.4	10.0	10.3	9.8	10.4	10.1	9.8	**9.6**
Excises	4.7	5.0	5.0	5.1	5.3	5.5	5.7	5.8	**5.6**
Taxes on international trade	1.7	1.4	1.1	1.0	0.8	0.8	0.7	0.7	**0.7**
Other taxes	1.3	1.5	1.3	1.2	1.1	1.4	1.4	1.4	**1.4**
Non-tax revenue	4.9	5.2	5.0	5.0	4.2	4.1	4.5	4.3	**4.2**
Capital revenue	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	**0.0**
Grants	0.2	0.2	0.1	0.1	0.1	0.2	0.2	0.2	**0.2**
Expenditure	**44.2**	**44.6**	**43.1**	**46.6**	**43.5**	**46.8**	**44.6**	**42.4**	**40.7**
Current expenditure	40.1	40.0	38.9	42.5	40.8	43.0	40.6	38.5	**37.1**
Wages and salaries	10.5	10.1	10.0	10.5	10.1	10.1	9.1	8.2	**7.4**
Goods and services	7.3	7.5	7.3	8.0	7.2	7.8	7.6	7.4	**7.4**
Interest	0.8	1.1	1.3	1.9	2.4	3.0	3.5	3.9	**4.0**
Subsidies	2.2	2.5	2.4	4.1	3.3	4.0	2.6	2.3	**2.4**
Transfers	19.3	18.8	17.9	18.1	17.7	18.1	17.8	16.7	**16.0**
Pensions	13.4	12.8	12.4	13.2	12.8	13.1	12.4	11.8	**11.3**
Other transfers	5.8	6.0	5.5	4.8	4.9	5.0	5.4	4.8	**4.7**
Capital expenditure	3.2	3.4	3.3	3.3	2.1	2.6	3.1	3.1	**3.0**
Net lending	0.7	1.0	0.7	0.5	0.3	0.3	0.1	0.1	**0.1**
Amortization of activated guarantees	0.1	0.2	0.2	0.3	0.2	0.8	0.8	0.7	**0.5**
Fiscal balance (cash basis)	-4.2	-4.5	-4.7	-6.9	-5.4	-6.6	-5.1	-4.0	**-3.2**
Augmented fiscal balance (incl. amortization of called guarantees)	**-4.3**	**-4.7**	**-4.9**	**-7.2**	**-5.6**	**-7.5**	**-5.9**	**-4.7**	**-3.8**

Note: The fiscal deficit in this table differs from the Government's Fiscal Strategy for 2015-2017 since, as of 2014 the Ministry of Finance changed the methodology for consolidation of the general government data by calculating both the general government wage bill and collected social contributions on a gross basis, i.e. without netting out contributions paid by the employer. As a result the level of revenues and expenditures in tables in the Fiscal Strategy are higher than in this document.

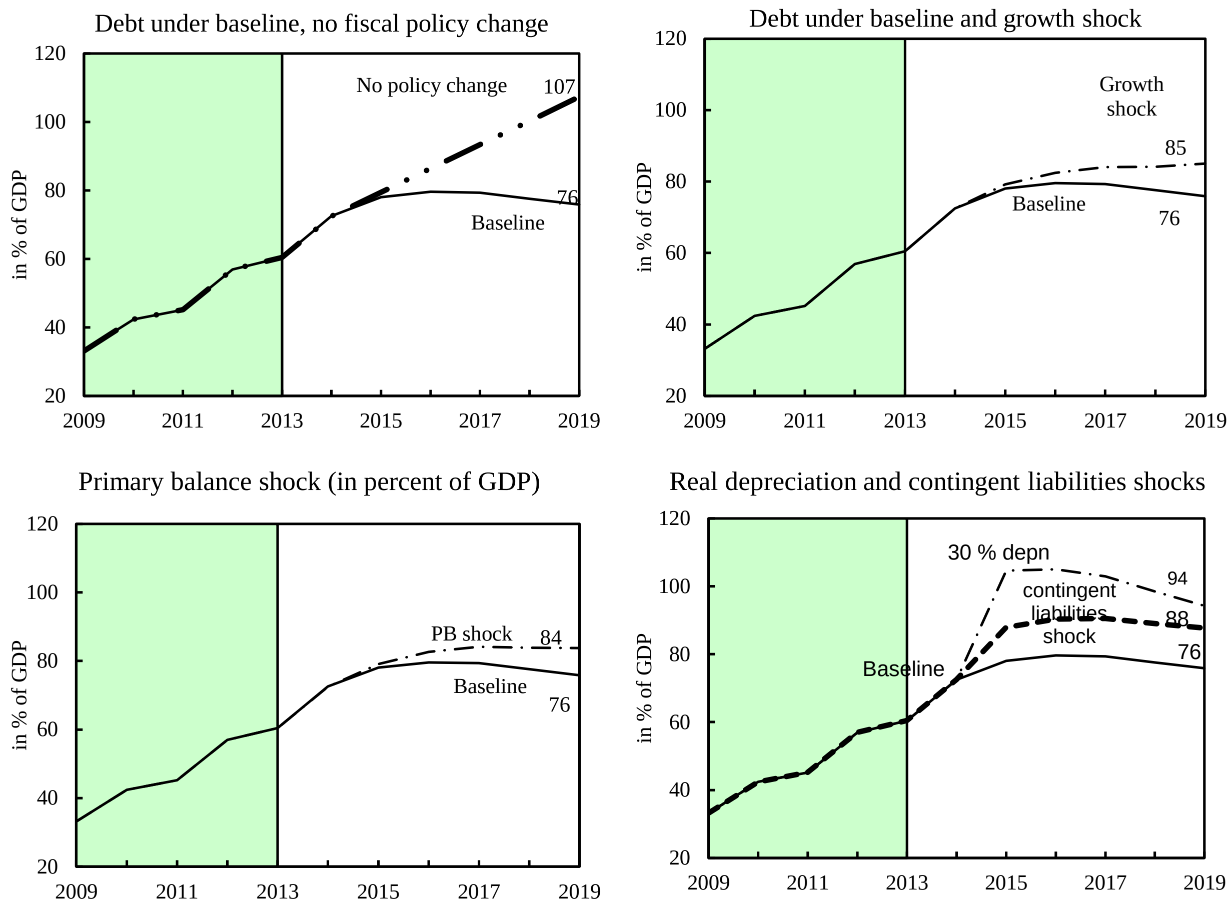
Source: IMF; Ministry of Finance, WB staff estimates.

Debt sustainability analysis

23. **A debt sustainability analysis shows that under a baseline scenario, public debt-to-GDP will reach 79.6 percent in 2016 after which it will begin to decline.** The baseline scenario assumes that the real GDP growth remains as in government projections and that the fiscal consolidation strategy is implemented as planned, with the primary deficit declining from 4.9 percent of GDP in 2014 to 0.8 percent by 2016 and thereafter moving into a small primary surplus. The government's gross fiscal financing needs will remain significant over the near term, of the order of 15-20 percent of GDP.

24. **The projected public debt path is highly sensitive to any slippages in the fiscal consolidation plan, weaker-than-expected growth or to a negative real exchange rate shock (Figure 1).** Indeed, both lower-than-anticipated GDP growth and a higher-than-envisaged primary deficit (compared to the baseline) by half a standard deviation would push Serbia's debt ratio to around 85 percent by the end of the projection period (and still rising in the case of weakening growth). Similarly, a one-off real depreciation of 30 percent or a one-off realization of 10 percent of GDP in contingent liabilities will push the public debt ratio up to between 88 and 94 percent of GDP. Even a more moderate real depreciation of 10 percent in 2015 would move the debt ratio up to 85 percent in 2015 and 2016, i.e. 6 to 7 percentage points above the baseline, while a combination of smaller slippages could lead to the debt ratio continuing to rise through the projection period.

Figure 1: Serbia: Public Debt Sustainability 1/ 2/



Source: Serbia Ministry of Finance, IMF, World Bank staff projections.

1/ Shaded areas represent actual data. Individual shocks (growth, primary balance) are permanent one-half standard deviation shocks from historical ten-year average from 2015.

2/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2015, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Risks to the Macroeconomic Policy Framework

25. **There are significant downside risks to the macroeconomic framework, both external and internal.** External risks relate to lower-than-expected economic recovery in the Eurozone which would have an adverse effect on Serbia's economic outlook through exports, remittances and capital flows since the EU countries are Serbia's largest trading partners. Adverse shocks to capital inflows, for example, relating to the normalization of US interest rates or negative spillovers from other emerging economies, could also pose risks to the outlook given Serbia's refinancing needs and foreign currency debt burden. A deterioration of the financial situation of foreign parent banks could similarly jeopardize credit recovery and undermine growth**.** On the upside, given Serbia's sizeable dependence on oil and fuel imports, a stabilization of oil prices at their current low levels would support current account adjustment. Key domestic risks arise from

the difficulty to circumscribe the issuance of new guarantees - especially to natural gas monopoly Srbijagas - and to reduce subsidies as intended. Without reforms that would tackle public utilities, a stricter control of the issuance of new guarantees may prove politically difficult. If some of these fiscal risks, or a weakening in growth or the currency, were to materialize the government would need to undertake even greater fiscal consolidation efforts in 2015 and 2016 to ensure that public debt remains sustainable. To mitigate these risks, the Bank is working closely with the government and the IMF to ensure that the reform of state owned enterprises and public utilities remains on track and that it generates the required fiscal savings.

Adequacy of the macroeconomic policy framework

26. **While there are risks, the macroeconomic policy framework is considered adequate for the proposed operation**. The framework is supported by the IMF. Public debt is projected to stabilize in 2016 and begin to fall afterwards. More critically, the long-delayed enterprise sector reforms supported by this DPL will contribute modest fiscal savings to the budget in the form of reduced direct subsidies in the short term and even larger savings in indirect subsidies as well as improved economic efficiency over the medium term. The authorities are confronted with a difficult economic context and clearly recognize the danger of unsustainable debt and are committed to adjust fiscal policy as needed to maintain debt sustainability over the medium term.

C. IMF RELATIONS

27. **The Executive Board of the International Monetary Fund (IMF) approved a three-year, SDR 935.4 million (about €1.2 billion, 200 percent of quota) new Stand-By Arrangement for Serbia on February 23, 2015**. The Serbian authorities have indicated their intention to treat the program as precautionary. The program is based on three main pillars: restoring public finances' health; 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 Bank and Fund have worked in close cooperation, for example, with the Bank working both with the government and the Fund team in providing upstream inputs on public enterprise restructuring as part of the design of the SBA; in helping the government develop a clear, time-bound restructuring plan for these public enterprises; and in assisting with the complex dialogue on the energy tariff reform. The Bank intends to continue this close cooperation as the Fund program moves into implementation.

III. THE GOVERNMENT PROGRAM

28. **Government's economic policy program is strategically oriented towards accelerating the EU integration process.** Serbia obtained the candidate status for membership in the European Union on March 1, 2012 and the Council of the European Union made the decision to open accession negotiations with the European Union on June 28, 2013. In order to obtain faster full EU membership, Serbia is committed to speed up the implementation of economic reforms and the fulfillment of the political and economic criteria set by the Council of Europe in Copenhagen, as well as the fulfillment of the obligations under the Stabilization and Association Agreement, to

ensure the establishment of a market economy, macroeconomic stability, and the rule of law while combating corruption and organized crime.[7]

29. **The Government's economic program defined in the *Fiscal Strategy for 2015-17* will focus on ensuring economic and financial stability, stopping further debt accumulation and creating an environment for economic recovery and growth to foster employment and raise living standards.** These goals will be achieved primarily through fiscal consolidation measures and an acceleration of structural reforms to remove existing bottlenecks to economic growth. Structural reforms are organized in two broad sets. The first set focuses on reforming the real sector and includes the following reforms: strengthening the business environment by ensuring greater predictability, better coordination of different agencies, and more efficient incentive policies; reforming the labor market; reforming and streamlining of the system for issuing construction permits; upgrading of the critical transport infrastructure. The second set focuses on structural reforms of the public sector, and encompasses a broad set of measures including: reform of the system of social protection; overhauling of the state administration; reforms of the state owned enterprises and companies in restructuring; strengthening public finance management; reforms of the pension, healthcare, and education systems; strengthening financial stability.[8]

30. **The reform of state-owned enterprises is critical to the success of GoS's economic program, contributing to medium term fiscal consolidation efforts, as well as economic recovery through improved economic efficiency.** There are about 1,200 state owned enterprises employing about 15 percent of the formal Serbian workforce (250,000 employees). These enterprises include several major public utilities, which are among the largest companies in Serbia, as well as numerous companies of various sizes and from various sectors. Heterogeneous in nature, they can be segmented in two groups: (i) state and socially owned enterprises, and (ii) municipally owned enterprises. The first group includes public utilities, commercial companies, and companies in the Privatization Agency portfolio. The breakdown and main indicators for various types of public sector enterprises is shown in Table3. The pervasive role of public enterprises and their relatively poor performance which requires State support, creates significant distortions and misallocation of production factors, deterring private sector investments. Poverty reduction and shared prosperity in Serbia has closely tracked economic growth. The SOE reform will help unleash private sector investment, contributing to private sector-led growth and share prosperity.

31. **Overall, public sector enterprises make significant net losses, which in 2013 amounted to approximately 3 percent of GDP or EUR1 billion, and require significant state support to remain afloat**. Losses are spread across all types of public sector enterprises. There are few individual exceptions, most notably Telekom, which in 2013 had net profits of EUR135 million. To stay afloat, public sector enterprises receive significant direct budget subsidies and soft loans, as well as indirect support in various forms, including unpaid taxes and contributions, state guarantees for loans, arrears to other state entities and public utilities. These indirect forms of support generate significant contingent liabilities for the state. Across all categories of public enterprises, yearly cash outflows and equivalents that include direct budget subsidies, soft loans,

[7] The Stabilization and Association Agreement entered into force on September 1, 2013, it was followed in January 2014 by the first EU-Serbia Intergovernmental Conference and the initial screening of the Acquis chapters. The first Acquis chapters are expected to be opened during 2015.

[8] Government of Serbia, "Fiscal Strategy for 2015 with projections for 2016 and 2017."

payments for called guarantees and increase in arrears for unpaid taxes, contributions, and utility bills amounted to over 2.5 percent of GDP annually in 2010–2012 (Table 4).[9] The total stock of funds provided in the form of indirect support is also very significant: as of third quarter of 2014 the stock of guarantees is over 6 percent of GDP, and accumulated stock of arrears to state entities and public utilities are likely well over 8 percent of GDP. As a whole, this stock of contingent liabilities is estimated at over 14 percent of GDP (Table 4). While the direct fiscal impact of resolving these companies will be limited, the indirect impact, in the form of unpaid taxes and contributions and unpaid bills to public utilities, will be much more significant. Unpaid bills to utilities have a major spillover effect. For some, notably Srbijagas, unpaid bills from these ailing SOEs has resulted in support from the State budget to offset the cost of outstanding accounts payable (these arrears actually explain the bulk of Srbijagas's State guaranteed debt, estimated at EUR800 million or about 2.3 percent of GDP). Some of these companies also have significant arrears to other public utilities, such as Serbia Railways and Power company (EPS). Resolving the companies in the PA portfolio will ease the financial pressure on public utility companies and consequently reduce pressure on the state budget.

32. **Different types of SOEs in Serbia operate under different legal frameworks.** Public enterprises (PEs) operate under the "Law on Public Enterprises" (PE Law), which regulates PEs established by the RoS, municipalities, and autonomous provinces and also regulates activities of general interest for any company in Serbia, public or private. All but a handful of national SOEs – including some of the largest ones such as EPS, EMS, Post, Serbia Gas, Forestry Management, and Roads – and all 300 plus municipal utilities fall under the PE law. A second group of enterprises have been corporatized into mostly joint stock companies (JSCs) or in fewer cases to limited liability companies (LLCs), including Telekom, Galenika, Jat Aircraft Maintenance, Belgrade Airport, and Railroads. These companies operate under the new Company Law that came into effect in February 2012. In addition to these two laws, the Founding Acts and company's articles of association (except for limited liability companies) also govern the rights, duties, and liabilities of the "founder" (in case of PEs) or the "shareholder" (in case of JSCs/LLCs) towards the enterprises and vice versa. The activities of both groups of enterprises are also regulated by sector-specific laws although these laws focus more on sector policy-making and regulation rather than governance. Further complicating things, governance of companies in the PA portfolio is still defined by provisions from old Company Laws from 1990s and first half of 2000, which for other companies have been abolished by the new company law from February 2012.

33. **The allocation of direct and indirect government subsidies continues to be made largely on a non-transparent basis and without explicit cost-benefit analysis.** Given the fragmentation of state support to public enterprises, the transparency of the funds allocation remains very low. The government does not maintain an integrated, company specific inventory collecting information on the different forms of state support received by each enterprise. Similarly, obtaining a comprehensive picture of these different forms of state support to determine not only their size but also their expected impact remains extremely cumbersome. As part of EU accession preparation process, the government has initiated reforms in state aid, aiming at improving on the fragmented process and introducing clear rules. A new Law on State Aid Control was adopted in 2009, and a Commission for Control of State Aid has started working from 2010.

[9] Until 2011 significant support came in the form of payments for covering arrears to pension contributions, but these were ruled unconstitutional and have since stopped.

The Commission is tasked with collecting data on all forms of state aid and to evaluate (both ex-ante and ex-post) whether individual decisions on state aid are in accordance with the Law. The Commission is gradually building its capacity and increasing the scope of activities, but has very limited coverage of state aid to SOEs in its activities. [10]

[10] According to the Law on State Aid Control "state aid is any actual or potential public expenditure or realized decrease in public revenue which confers to state aid beneficiary a more favorable market position in respect to the competitors and as a result causes or threatens to cause distortion of the market competition."

Table 3. Overview of non-financial state owned enterprise sector (2013 unless otherwise indicated)

	No. of companies	Operating revenues (EUR Million)	Net profit/loss (EUR Million)	Assets (EUR Million)	No. of employees
TOTAL (est.)	**1,215**	**8,854**	**-1,055**	**34,190**	**251,848**
1. State and socially owned enterprises (est.)	**566**	**7,301**	**-1,007**	**30,613**	**181,496**
1.1. Public utilities	**24**	**3,560**	**-323**	**20,031**	**77,078**
1.1.a. Large	6	3,353	-325	18,480	70,462
EPS	..	1,943	166	9,558	31,569
Railroads	..	233	-73	2,428	19,896
Post (core company)	..	201	25	305	15,133
Srbijagas	..	610	-449	1,443	3,011
Srbijagas core company	..	583	-439	1,414	1,181
EMS	..	168	14	751	1,348
Roads	..	225	-9	4,024	1,335
1.1.b. Other (estimated)	18	207	2	1,551	6,616
1.2. Commercial companies (est.)	**~30**	**~1,200**	**~10**	**~2,300**	**~18,500**
1.2.a. Selected large companies	5	1,092	9	2,156	16,404
Telekom (core company)	..	765	135	1,639	9,073
Smederevo steel smelter	..	189	-132	218	5,036
Jat tehnika	..	25	0	20	953
Prvi Partizan	..	54	5	67	889
Airport Belgrade	..	59	0	211	453
1.2.b. Other (excluding banks)	~25	**..**	**..**	**..**	~2,000
1.3. Privatization Agency portfolio	**514**	**2,449**	**-693**	**7,551**	**90,303**
1.3.a. Companies previously in restructuring	140	1,284	-488	5,876	55,330
1.3.b. Other	374	1,165	-205	1,675	34,973
2. Municipal enterprises (est.)	**649**	**..**	**..**	**..**	**70,352**
2.1. Municipal utilities (data for 2012)	352	1,281	-46	3,110	55,583
2.2. Other (data for 2010)	297	..	..	..	14,769

Source: Agency for Business Registries, Privatization Agency.
Note: Financial results of large utilities are quite volatile, e.g. in 2011 two large public utilities (EPS and Railroads) had a significant accounting adjustment contribute to their profits. EPS booked an adjustment of value of its fixed assets as a revenue item which improved the overall result by about EUR 485mn. Railroads had in 2011 signed an agreement with the Government whereby large part of its debt related to international creditors was moved off the Railroads books and taken over by the Government. This was accounted as a revenue item, boosting overall result by about EUR 200mn. Also, Railroads had an adjustment of value of fixed assets, boosting overall result by further EUR 22mn. When adjusting for these one-off items, EPS net profit for 2011 of EUR 263mn turns into a net loss of EUR -222mn, and Railroads net profit of EUR 125mn turns into a net loss of EUR -97mn. In 2012 EPS had a net loss of about EUR -25mn, and Railroads a net loss of about EUR -150mn.

Table 4: Support to public enterprises (in percent GDP)

	Yearly "cash" transfers to public enterprises (average of 2010–2012)		
Recipient	*Direct budget subsidies*	*Debt service of SOE debt by government*	*Increase in arrears for unpaid taxes, contributions and utility bills*
Privatization Agency portfolio	0.3	0.0	0.9
State Owned Enterprises	0.6	0.4	n/a
Municipal Enterprises	0.7	0.0	n/a
Total	**1.6**	**0.4**	**0.9**
	Accumulated stock of contingent liabilities generated by public enterprises (as of end-of 2013 unless otherwise indicated)		
Recipient	*Stock of Government guarantees*	*Arrears to state entities*	*Arrears to public utilities*
Privatization Agency portfolio	1.0*	5.7	1.3
State Owned Enterprises	5.3*	0.9**	0.3**
Municipal Enterprises	0.0	n/a	n/a

Sources: Ministry of Finance, Privatization Agency, World Bank Staff Estimates.
*/ Data for September 2014
**/ Data for end-2011
Notes: Data on direct subsidies, debt service for SOEs and stock of government guarantees are actual data from Ministry of Finance. Data on arrears to state entities and arrears to public utilities are World Bank staff estimates based on partial data obtained from Ministry of Finance and Privatization Agency.

IV. THE PROPOSED OPERATION

A. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

34. **The proposed operation would be the first in a programmatic series of two operations supporting Government of Serbia's structural reform program for the state owned enterprises sector, which is at the core of GoS' economic program for 2015-17.** The development objectives of the series will be: (i) to reduce the levels of direct and indirect state support it receives; (ii) to improve governance, performance monitoring, and accountability framework of state owned enterprise sector; and (iii) to mitigate the short term social and labor impacts of SOE restructuring and disposition plans. These objectives will be achieved by supporting measures organized in the following three pillars: (A) completion of restructuring and divestiture program for companies in the Privatization Agency portfolio and selected state owned enterprises operating in the commercial sector; (B) strengthening governance regulatory and institutional framework, and monitoring and transparency arrangements for improved performance and accountability of state owned enterprises; and (C) mitigating the Social and Labor Market Impact of the reform program.

35. **This operation is fully congruent with World Bank Group (WBG) objective of shared prosperity.** Improved performance of the public enterprise sector and reducing the direct and indirect subsidies channeled to this sector will contribute to stabilize debt accumulation, enable a

reallocation of resources to more efficient uses and create the conditions for economic recovery and growth fostering employment and raising living standards. According to the latest data available (HBS 2010) the unemployed are overwhelmingly represented in the bottom 40 percent of the population (20 percent versus 14 percent on average and 8 percent in the upper three quintiles). The adult population in the bottom 40 percent has lower education than the average population, and almost 50 percent (as opposed to 36 percent in the population as a whole) have no education or incomplete primary education. Only 5 percent of individuals in the bottom 40 percent have attained tertiary education, as opposed to 12.5 percent in the population as a whole (two and a half times more). Over a quarter of those in the bottom 40 percent are employed in elementary occupations (e.g. manufacturing, mining, agriculture) which account for 17 percent of employment in the population overall. Other salient characteristics of those in the bottom 40 percent are belonging to households of larger size and being located in rural areas. Due to a high incidence of children in this group versus the rest of the population, the average age in this group is three years less than average (41 years old as opposed to 44 years old).

36. **The State Owned Enterprises Reform DPL program builds upon the experience accumulated during the preparation and implementation of previous private and financial sector operations in Serbia during the past decade.** Previous experiences in public enterprise restructuring in Serbia showed that reform implementation is heavily dependent upon an effective champion who takes ownership of reforms. Many of these reforms are controversial and impact a large number of workers, it is critical that these champions clearly articulate the benefits of reform to the public. Also, given the strong vested interests involved, improving SOE governance will require unwavering political support to drive the program. Success of past divestiture programs in Serbia and other transition economies also hinged on ensuring transparency of the process, with a well-defined and enforced legal framework and regulatory framework. Another important lesson is that the reforms should be designed in a manner to minimize possibilities for later reversal. Finally, the need to address squarely the timing and design of social policies or programs aimed at mitigating the adverse social impacts potentially caused by the transition is another important lesson of earlier privatization efforts in Serbia and elsewhere.

B. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar A- Accelerating the divestiture program for Privatization Agency Portfolio and selected State Owned Enterprises operating in the commercial

37. **The key development objective under this first pillar is a reduction of state participation and level of direct and indirect support in the real sector.** Results will be measured by levels of annual direct subsidies and soft loans channeled to these enterprises, the accumulation of new tax and social contribution arrears, the accumulation of arrears to public utilities. Baseline and target values are detailed in the Policy and Results Matrix (Annex 1).

Prior action #1: Enact a new Privatization Law, and amendments to the Bankruptcy Law and Privatization Agency Law to facilitate and accelerate the disposition of Privatization Agency portfolio.

38. **The legal and regulatory framework for privatization was amended in order to facilitate and accelerate the disposition of companies in the Privatization Agency portfolio.** The previous Privatization Law established an open ended moratorium prohibiting the initiation or continuation of debt enforcement actions against entities in restructuring, effectively sheltering loss-making enterprises from having to satisfy obligations to creditors until the restructuring process is terminated. This mechanism was designed to give additional time to management of highly indebted companies to work out a plan to turn them around or organize an orderly disposition. In practice, however, this restructuring mechanism largely failed, as the absence of time and budget constraints provided no incentives to management of these companies to finalize the restructuring plans. To remediate this situation a sunset date for all ongoing restructuring under privatization was introduced in 2012. This change was reinforced by a decision from the Constitutional Court, November 14, 2013, which established that protection of debtors under restructuring regime was unconstitutional. In principle, creditors will be able to seek debt enforcement actions – which would de facto trigger bankruptcy procedure – from May 2015, which puts an additional pressure on the authorities to swiftly complete the resolution of companies in restructuring. Further changes were introduced to the Privatization Law in August 2014 to facilitate the disposition of enterprises while introducing timeline for completion of the process. In addition to existing equity sale and bankruptcy resolution options, the new Privatization Law established new modalities of privatization, including asset sales and strategic partnership. It also introduced conditional write-off of debt towards state creditors accumulated up until end-2013, a measure aimed at making enterprises with a viable business more attractive to investors. Finally, the Bankruptcy Law and Privatization Agency Law were amended to ensure congruency with the new Privatization Law, notably with respect to Agency's role under bankruptcy procedures.

Prior action #2: Adopt Decisions on method, models, and measures for at least 140 PA companies to be resolved using the capital sale or asset sale model and for 19 micro PA companies; and Adopt the Action Plan for the 188 PA companies to be resolved through bankruptcy.

39. **This operation will support the decisions on the resolution method for all enterprises in the PA portfolio.** As provided for under the new Privatization Law, the authorities collected Letters of Interest (LOIs) from potential investors for all companies, and on that basis prepared initial proposals for resolution of each individual company from the PA portfolio. On the basis of these proposals, the MOE (in case of companies with majority socially owned capital), the Government (in case of companies with majority state owned capital), or local governments (in case of companies with majority local government owned capital) adopted formal decision on the resolution model. The authorities have decided that the companies from the PA portfolio will be resolved using the following models: (i) a group of 188 companies with about 5 thousand workers will be sent to bankruptcy; (ii) for 147 companies, with about 24 thousand workers, equity sale will be attempted; (iii) for 30 companies, with about 12 thousand workers, asset sale model will be used; (iv) for 3 companies, with about 3 thousand workers, a combination of models will be used; (v) for 24 companies, with about 29 thousand workers, strategic partnership model will be used; (vi) for 19 micro companies with about 200 workers separate decision by the PA will be taken on privatization model; (vii) for 7 companies further valuation data is needed and this process has been initiated. In addition, there are 96 companies with approximately 15 thousand workers, for which the privatization process has been suspended. This includes companies based in Kosovo, and companies which were founded by former Yugoslav republics. It also includes several companies where court cases are ongoing, and once they are completed the privatization is

expected to be restarted. Implementation of the selected resolution mechanisms will be supported primarily by the second DPL. The authorities remain committed that the environmental assessment for the companies from the PA portfolio will be updated as required before their disposition. Similarly, follow-up of implementation of action plans and post-privatization compliance reports for companies to be divested will be strengthened. As needed, the sales contracts shall include provisions and measures such as an assessment and allocation of liability for environmental damage, and settlement of debts of the ex-owner on account of pollution or damage to the environment.

Prior action #3: The borrower has launched the implementation of the new Privatization Law: (i) initiation of bankruptcy procedures, through letters from the Privatization Agency to the relevant commercial courts for 76 PA companies with no employees; (ii) public bid announced, under the equity or asset sale model, for at least two PA companies that were in restructuring as of August 13, 2014; (iii) Programs for asset sales delivered to the PA by at least eight PA companies, that were in restructuring as of August 13, 2014; (iv) Government adopts a decision on a strategic partnership for at least two PA companies.

40. **This operation will support initial implementation of the disposition process.** The PA portfolio includes approximately 76 companies with no workers and about 50 more companies with less than five workers. Resolving these companies immediately will send an unequivocal signal that the Government is determined to tackle this long delayed agenda. For other companies that are set to go to bankruptcy, the PA also needs to move decisively while ensuring that the workers from these companies receive proper financial compensation in lieu of severance packages.[11] For companies where one more attempt at privatization will be made – either through equity sale or asset sale – the momentum needs to be maintained by initiating public bids. The authorities are determined to pursue their efforts to attract private investment in selected large state-owned enterprises, for which strategic partnership model will be used. The Government is seeking to conclude a management contract for Smederevo Steel Mill, which has been a significant drain on public resources. Government also indicated that it intends to privatize several other state owned companies operating in the commercial sector that are not currently in the Privatization Agency portfolio, most notably Telekom.

41. **The second operation will continue to support implementation of the resolution of companies from the PA portfolio.** By the time of the second operation all of the companies that were previously in the status of restructuring - i.e. the most problematic part of the portfolio – are expected to be resolved. For a majority of the other companies in the PA portfolio, the resolution process would also have to be completed by the time of second operation. In respect to environmental damage occurred prior to the entities disposition, the authorities will elaborate on the provisions of the Law on Privatization concerning past environmental damage and eliminating environmental risks in the Law on Environmental Liabilities which is under preparation. The PA will further strengthen its capacity for implementation of these provisions of the Law on Privatization. Proposed triggers for second operation: *Trigger # 1 - Out of 140 PA companies that were in restructuring as of August 13, 2014, at least 100 have been resolved; Trigger # 2 For PA*

[11] None of the firms in the PA portfolio have financial resources to actually pay severance pay. Instead of severance pay, the government offers financial compensation packages to workers; it is then for workers to decide if they accept those packages and leave the company, or stay in the company, but facing an uncertain future with possibly no severance pay at all once the company is dissolved.

companies that were not in restructuring as of August 13, 2014, public bids were announced for at least 20 PA companies.; Trigger # 3- Ministry of Agriculture and Environmental Protection has assessed the potential environmental damages for at least180 PA companies - including those in bankruptcy for which the PA is the bankruptcy administrator - and prepared a report on scale of environmental damages and initial cost estimates for addressing such liabilities in all of those PA companies where potential environmental damages were identified.

Pillar B - Strengthening governance regulatory and institutional framework, and monitoring and transparency arrangements

42. **The measures supported under this pillar seek to improve the performance, governance and accountability of state owned enterprises, with a particular focus on public utilities**. The measures encompass amendments of the legal and regulatory framework in line with international standards and practices, and concrete steps towards their implementation. Improved governance and accountability framework is expected to have a direct impact on the performance of state owned enterprises, and thus contribute to lower demand for direct and indirect state support, especially for recurrent expenditures. Improved corporate governance and accountability would also contribute to attract private investment in public enterprises.

43. **Poor operational and financial performance in the SOE sector is driven primarily by weak monitoring and corporate governance arrangements, linked to political influence in the decision making and operations of SOEs.** The SOE ownership functions are largely decentralized, with line ministries responsible for sectoral policy-making as well as for the operations and supervision of public enterprises in their portfolio. This decentralized system has significant shortcomings, which compromises the ability of the Government to successfully manage the companies and creates opportunities for excessive political interference. It creates a potential conflict of interest between ownership and policy-making functions, undermines ownership focus and diffuses accountability. Further, PE Law which was in place until December 2012 had major shortcomings related to corporate governance.[12]

Prior action #4: For the 24 Public Enterprises for which the Republic of Serbia is the founder, and subject to the Law on Public Enterprises: adopt new Statutes and Founding Acts and appoint the supervisory boards in at least 15 of them; and establish audit committees in line with new legal environment in at least 10.

44. **To address critical weaknesses of the legal and corporate governance framework, the government developed a new PE Law which the Parliament adopted in late 2012.** The new PE Law includes provisions addressing most of the major weaknesses of the previous Law. It provides a good basis to modernizing the PE governance framework by addressing key legal gaps and enabling the implementation of principles of depoliticizization and professionalization. The new PE Law provides companies a choice of two models of corporate governance for PEs - one-tier and two-tier system – similar to the one provided for under the Company Law. The two tier model

[12] For example, governance structure included a Supervisory Board with no real competencies, Management Boards that performed limited competencies of the owner, and "omnipotent" general managers. All of them were directly appointed by the government so there was no real subordination and supervision between these bodies. No criteria were in place for the appointment of any of the members of such bodies and duties of care and/or loyalty prescribed.

gives stronger powers to the Supervisory Board, which becomes a strategic corporate body overseeing the management with clearly defined mandate and functions, including internal audit and controlling ones. The new law also introduces educational and professional criteria for the selection of the Supervisory Board members, as well as clearer criteria related to the dismissal of Board members. It also introduces an independent member of the Supervisory Boards, albeit the criteria of independence for Supervisory Board members as currently stipulated do not seem to provide the expected standards of independence. A significant new provision in the law is the requirement to nominate all general managers of PEs in public competition procedure, followed by a formal and regulated selection procedure. A possibility of performance-related bonuses has been introduced by the new law. The new law also introduces criteria for dismissal of the general manager (both obligatory and discretionary), where no such rules existed in the old law. The new law specifically provides for an obligation to perform audit of financial statements of each PE, and a further obligation of all national level PEs to institute an audit committee. Finally, new PE Law brought significant improvements related to transparency and disclosure. This includes making annual business plans public, introducing quarterly reporting to Ministry of Economy and the obligation to present a special program related to the usage of any state aid.

45. **This operation will support the implementation of the new legal and regulatory framework for PE.** Individual PEs are required to harmonize their Founding Acts and Statutes with the provisions of the new law. As of January 2015, out of the 24 Republican level PEs 21 have adopted new Founding Acts and 17 have adopted the harmonized Statutes. Supervisory Boards in line with the new 2012 PE Law have been appointed in 22 companies. Public selection process for general managers has been initiated in majority of PEs, and completed in three PEs. Audit committees have been established in 12 PEs.

46. **To further consolidate the improvements to PE corporate governance framework, remaining gaps in the new PE Law will be addressed as part of the second DPL.** The second DPL will support defining the criteria, in line with the PE law, for dismissal and performance bonuses of Board members and managers. In the new law, non-fulfillment of the annual business plan and/or non-fulfillment of the key performance indicators, is a single discretionary reason for dismissal of Board members and one of the reasons for dismissal of the manager, but the Law provides no specific guidance for the implementation thereof. Instead, criteria clearly linked to the achievement of key performance indicators that would be agreed to between the government and the PE in advance and publicly disclosed would be a much more objective and sustainable solution. Similarly, a by-law which specifies criteria and conditions for performance related bonuses will be drafted, as an important mechanism for motivating and attracting professionals. Proposed trigger for second operation: *Trigger # 4 - Adopt the legal framework on accountability mechanisms indicated in the PE Law for dismissal of General Managers and Board members and the introduction of performance bonuses.*

47. **To accompany the process of corporatization envisaged in some large PEs, the legal framework should be further enhanced to ensure continued adequate oversight of the corporatized state owned enterprises.** The checks and balances provided for under the common corporate governance rules in the Companies Law do not provide sufficient comfort for the adequate supervision and functioning of the SOEs where the State is either a single shareholder or a dominant shareholder. The State has shareholdings in numerous, important and complex companies, and given the status of administrative resources in Serbia, it is not realistic to expect

the government to perform the usual role of a diligent owner and shareholder in all such companies. Therefore, additional rules outside of the scope of the corporate governance rules laid by the Companies Law, should be instituted to regulate SOEs so as to enable: (1) better control and supervision of SOEs by the government (such as the obligation to submit to the government for approval the annual business plan), (2) increased transparency of SOEs activities and governance to the public (such as imposing on them the same transparency requirements as are currently required for all publicly listed companies), and (3) enhancement of the selection process of board members and key managers (such as a public procedure for the appointment of general managers). However, such rules should be designed so as not to significantly decrease SOEs competitiveness on the market. Proposed trigger for second operation: *Trigger # 5 - Adopt legal framework to ensure full congruency so that corporatized SOEs are adequately monitored and maintain high standards of transparency and disclosure.*

Prior action #5: Public Oversight Board for Auditing in the Republic of Serbia has been established pursuant to the Law on Auditing, and is fully operational, conducting public oversight of the quality of performance and operations of the audit profession in Serbia, in line with the Law, by, inter alia, issuing opinions, making recommendations and proposing corrective measures.

48. **This operation will support the implementation of the new legal framework for accounting and auditing, which will be critical to strengthen corporate governance, accountability, and performance assessment including for state-owned enterprises.** The new Law on Accounting and Law on Auditing enacted in July 2013 are an important step towards the effective introduction of international standards and the transposition of the *Acquis Communautaires* in financial reporting and audit. The new laws established financial reporting and auditing requirements for micro, small and medium, and large and public-interest entities. International Financial Reporting Standards (IFRS) were designed for listed companies and other "public interest entities" and not for smaller companies and enterprises, for which they represent an unnecessary accounting and financial reporting burden. As a result of the new accounting laws, some 147,000 enterprises that are de-facto small and medium enterprises (SMEs) will report annually using the IFRS for SMEs. Micro enterprises will have a simplified reporting system, tailored to the information needs of this sector, which further reduces unnecessary costs and burden. The Auditing law introduced quality assurance and a system of public oversight over Statutory Auditors. Improved quality of financial information, the introduction of public oversight for the audit function, and the strengthening of quality assurance systems for audit, are all critical to corporate governance, accountability, and performance assessment, and should help attract investment, including in State-owned enterprises.

49. **The second operation will continue to support the implementation of the new accounting and auditing legal environment in state owned enterprises.** Implementing the new legal environment in all SOEs will require significant time and resources. The second operation will support authorities' efforts focusing on public enterprises at the Republic level. Further efforts, beyond the duration of the series, will be needed to expand this to effectively implement new legal environment for all state-owned enterprises, including at the municipality level. Proposed trigger for second operation: *Trigger #6 - Establish audit committees in all Public Enterprises for which the founder is the Republic of Serbia and are subject to the Law on Public Enterprises.*

Prior action #6: Establish quarterly business monitoring as provided for under Article 52 of the PE Law and Decree for Template on Quarterly Reporting on fulfillment of annual plans of Public Enterprises and their subsidiaries (published in Official Gazette 36/13 and amended in Official Gazette 27/14).

50. **This operation will support the establishment of the new reporting procedures and improvements in transparency and disclosure brought by the new PE Law.** Authorities have established a system of quarterly reporting by all PEs (including municipal utilities). The reports include detailed data on financial performance of companies, including quarterly income statements, balance sheets and cash flow statements. The reports also include detailed data on liabilities, arrears to other state entities and to private companies, as well as data on employment and wages, and on prices charged for services. In addition, authorities have developed preliminary key performance indicators (KPIs) for the largest energy sector public utilities. These KPIs will be further refined by a separate Bank operation which is being considered and would focus on four largest utilities in the energy and transport sectors. The ultimate goal is to provide the government with a clear set of parameters on strategic direction of the company and an understanding of the operational reasons that lead to financial constraints. This will help the government in setting reasonable and feasible targets coherent with strategic policy goals, and in line with funds allocated to support the PEs.

Pillar C – Mitigate the social and labor market impact of SOE reforms

51. **Measure supported under this pillar will seek to mitigate the short-term labor and social impacts of implementation of the PA Action Plan.** The specific objectives are: (i) to ensure adequate financial protection of redundant workers of non-private enterprises; and (ii) to facilitate the transition into employment and provide a temporary safety net for vulnerable redundant workers. These objectives are particularly germane given the findings described in the Poverty and Social Impact Analysis section. The sustained and adequate funding of the social impact mitigating programs throughout the duration of the series will be critical.

Prior action #7: Adopt the governmental decree confirming and detailing the options and amounts for the social programs to be paid out in 2015. Provide sufficient funding (at least RSD 16 billion) in the Budget 2015 for financial assistance needed to mitigate the social impact of the disposition of companies in restructuring.

52. **The government is committed to providing adequate financial assistance to redundant workers.** The Government of Serbia has created a special budget-financed fund, the Transition Fund, which provides several options for financial assistance from which redundant workers can chose from in lieu of severance pay.[13] In the past, these options have included (i) packages ranging from EUR 100 to 500 per year of service; (ii) packages according to labor code provisions for severance pay, with subsequent access to unemployment benefits; and (iii) early retirement packages that paid financial compensation and long-lasting unemployment benefits until the person reaches retirement age. These compensation packages raised several issues, including with respect to their fiscal sustainability and equity within the public sector and vis-à-

[13] The offered packages are not considered severance pay since workers voluntarily chose to leave the company if they sign up for the program.

vis the private sector. The authorities have decided to address these issues and adopted a new Decree which aims at offering adequate and equitable financial compensation. Under the new Decree, the main package offers financial compensation as foreseen in the labor code, only taking into account work history with the last employer. This is an adequate package and also ensures equity between redundant workers in the public and private sector. Nevertheless, in order to avoid packages that could jeopardize financial sustainability of the proposed program, and to avoid abuse by workers that have high wages on record, but are actually paid less in reality, this package will be subject to caps. In particular, packages cannot exceed a total value of EUR 8,000 per redundant worker; and not more than EUR 500 can be accrued per year of service with the last employer. In addition, in line with past practice, a package of EUR 200 per year of service is being offered for the entire work history.[14] This package is targeted at low-wage earners who would receive relatively little under labor code provisions. A third option offers six monthly average wages to workers with a minimum of 15 years of work history, but this option seems redundant given what workers with a similar work history would receive under the other two options. In addition, a certain group of workers, employed by the companies that will go into bankruptcy, with long contribution histories would qualify for an old-age pension—albeit very small one—and therefore would not be eligible to any of the above financial compensation packages. For these workers, a small compensation of two monthly average wages is offered. Finally, because the packages offered under the proposed 2015 decree are by and large in line with labor code provisions, a number of redundant workers are expected to also qualify for unemployment benefits, which will ensure sustained financial assistance to redundant workers over a longer time period and link redundant workers with services offered by NES.[15]

53. **The Government is committed to allocate sufficient resources in the budget to provide financial compensation to redundant workers.** The average financial compensation package paid out by the Transition Fund (without the monthly early retirement payments) was worth about RSD 700,000 per beneficiary in the past. Additional payments for workers who in past have chosen the early retirement scheme (which is not offered anymore under the new Decree) amounted to RSD 2 billion a year. The 2015 budget allocation of RSD 16 billion, which could compensate about 20,000-25,000 redundant workers, is in line with the authorities' divestiture program, while also providing sufficient resources to continue payments under previous commitments.

Prior action #8: Include in the 2015 performance agreement of the National Employment Service (NES) a requirement for NES (i) to visit every company that plans to lay off more than 10 workers and inform workers about available NES services, programs, and benefits, register them with NES, and develop an individual action plan for each registered redundant worker; (ii) to contact at least 20 employers in the same and neighboring municipalities where the company resides to offer them NES services and inquire about job vacancies; and (iii) to consult with the local employment council about support for redundant workers.

54. **This operation will support efforts to better link redundant workers with services offered by the NES and job opportunities in nearby companies**. The local branch offices of NES are closely involved in the implementation of social programs for redundant workers of

[14] An additional provision ensures that no compensation is being paid for those years for which the worker has previously received severance pay.
[15] In the past, many redundant workers received packages in excess to labor code provisions, which disqualified them from receiving unemployment benefits.

public enterprises providing advice at several stages. In addition, the National Employment Action Plan, which outlines the annual provision of active labor market programs by the NES, has specific provisions for making ALMPs available to redundant workers form public enterprises. However, as shown by the results of the PSIA for this operation, redundant workers are often not aware of the services and assistance that are being offered by NES. Hence, the outreach of NES to redundant workers has to be improved. At the same time, such efforts should not crowd out the assistance that NES provides to other unemployed. The proposed prior action therefore requires NES to improve their initial outreach to all workers that become redundant, from public and private companies alike, register them with NES, and develop an initial individual action plan for each redundant worker. In line with best practice from other countries, the NES will be required to visit every company that announces redundancies of more than 10 workers and inform redundant workers about the services and programs available at NES, including about the eligibility criteria for unemployment benefits. In order to improve jobs prospects of redundant workers, NES will also be required to strengthen their efforts to register job vacancies in the surrounding area of the public enterprise where redundancies will occur. To this end, NES will have to contact at least 20 employers in the municipality where the redundancies will occur (or neighboring municipalities) and offer their services to employers to fill vacancies, therefore increasing the stock of registered vacancies in the local NES branch office and improving the prospects of re-employment of redundant workers. Similarly, NES branch offices are also part of the local employment councils. These are tri-partite institutions that bring together local representatives of trade unions, employers, municipal governments, and the NES to discuss employment initiatives – like, for example, public works programs, grants for start-up initiatives, and so on – and possible funding sources. Engaging with local employment councils could broaden the available support and opportunities for the re-employment of redundant workers. The annual performance agreement 2015 between MoLEVSA and NES will include requirements for NES to perform these activities and ensure that the necessary data to monitor their implementation is collected.

55. **The government is committed to improving the design of its public works program so that it can better serve as an additional safety net for vulnerable groups, including redundant workers.** The NES offers a range of labor market programs, including wage subsidies, start-up support, public works, re-training, job counseling, and job search assistance. Of these, public works is of particular importance because it gives the long-term unemployed, who have little to no chances of finding proper employment, the possibility to earn some income, at least for some months during the year. In that sense, public works are not an employment program with the objective to increase future employment prospects or participants, but rather an additional social safety net. To the extent that redundant worker are not able to find new employment – and evidence shows that a considerable share could end up as long-term unemployed – a well-designed public works program could fulfill this role of an additional safety net. In the case of Serbia, there might be need for such an additional safety net, because the last-resort financial social assistance – although very well targeted – is rather narrowly defined, excluding many poor people. Yet, the public works program in its current design raises concerns if it can fulfill this role. Well-designed public works program are self-targeted by paying considerably less than minimum wage; and the jobs done under public works are not replacing proper jobs. The government is considering re-designing the current public works program to pay a stipend instead of a wage; and to limit public works to less-than-full-time tasks that support communal activities like, for example, elderly care; to restrict eligibility for public works to long-term unemployed (more than one year, possibly two years of uninterrupted unemployment); and to limit the duration of public works to six months of

the year and person. Proposed trigger for the second operation: *Trigger # 7: The design and targeting of public works is improved so it can better serve act as an additional safety net for vulnerable groups, including redundant workers*.

56. **The government is committed to reducing disincentives for formal sector work—in particular mini-jobs and self-employment in micro-enterprises.** Past experience from privatization has shown that many redundant workers, especially older ones, have obsolete skills and end up in informal "mini-jobs"—that is, casual, low-paying part time work or self-employment in micro enterprises. To encourage formal job creation in this segment of the labor market—especially formal jobs that guarantee a minimum level of protection of workers—some of the significant disincentives have to be addressed. A significant disincentive is the minimum social security contribution. The minimum contribution is calculated from a base set at 35 percent of average wage and is not pro-rated by actual hours worked. Any job earning less than 35 percent of average wage—including part-time jobs—has to pay this minimum contributions. What makes Serbia unique is precisely that this floor is not even adjusted by actual hours work. That is, part-time jobs around the hourly minimum wage are penalized through this floor, making them unviable in the formal sector. This is also confirmed by data from the labor force survey, according to which this segment of the labor market is practically nonexistent in Serbia. Also, this minimum contribution might be a significant barrier for the employment of women, as in many Western European countries– often with care duties –form a significant share of part-time workers. Finally, all other countries of former Yugoslavia have already reformed this work disincentive; Serbia is the only one remaining with such a stringent floor. To provide better employment opportunities for redundant workers as well as for other vulnerable workers and women – which are over-represented among part-time workers – reforming the floor to either abandon at or at least adjust it by actual hours worked is essential to spur formal labor demand in this important sector. Proposed trigger for second operation: *Trigger # 8: The MoF, MoE and MoLEVSA will assess the impact of the existing social security regime on the labor market and propose measures to Government to remove disincentives for formal employment opportunities for low–paying part time work and self-employment, taking into account the medium term macro fiscal framework.*

57. **Other ongoing World Bank operations will support the NES and MoLEVSA to strengthen their capacities and improve service delivery for the unemployed.** In particular, the Word Bank supports MoLEVSA though a Technical Assistance program, co-financed by the European Commission, to prepare a new National Employment Strategy. This will be a comprehensive roadmap that involves various ministries and government agencies under the goal to foster job creation, improve institutions that are relevant for the efficiency of labor markets, and address labor supply issues like skills development and education. Importantly, the government has already identified weaknesses in the NES and the design of ALMPs and social benefits and committed to key reforms in these areas through a World Bank Results-based Financing loan on Competitiveness and Jobs. This combination of technical assistance and operational support should considerable enhance the capacity of NES to support redundant workers and improve the quality of their services and programs over the next four years.

Table 5. DPO Prior Actions and Analytical Underpinnings

Pillar A: **Accelerating the restructuring and divestiture program for Privatization Agency Portfolio and selected State Owned Enterprises operating in the commercial sector**
Prior action #1: Enact a new Privatization Law, and amendments to the Bankruptcy Law and Privatization Agency Law to facilitate and accelerate the disposition of Privatization Agency portfolio; **Prior action #2:** Adopt Decisions on method, models, and measures for at least 140 PA companies to be resolved using the capital sale or asset sale model and for 19 micro PA companies; and Adopt the Action Plan for the 188 PA companies to be resolved through bankruptcy; **Prior action #3:** The Borrower has launched the implementation of the new Privatization Law: (i) initiation of bankruptcy procedures, through letters from the Privatization Agency to the relevant commercial courts for 76 PA companies with no employees; (ii) public bid announced, under the equity or asset sale model, for at least two PA companies that were in restructuring as of August 13, 2014; (iii) Programs for asset sales delivered to the PA by at least eight PA companies, that were in restructuring as of August 13, 2014; (iv) Government adopts a decision on a strategic partnership for at least two PA companies..
Analytical Underpinnings: The approach to resolving the remaining companies from the PA portfolio embedded in the new Privatization Law incorporates key lessons learned from previous divestiture program in Serbia as well as other transition economies, notably: the importance of transparency of the process, with a well-defined and enforced legal framework and regulatory framework; the need to separate the policy, regulatory, and prioritization functions (MoE), from the entity executing the transactions, and the entity handling the restructuring or liquidation process (See for instance Goldberg and Nellis (2007), Methods and Institutions – How do They Matter?: Lessons from Privatization and Restructuring in the Post-Socialist Transition, in Lieberman and Kopf (ed.) *Privatization in Transition Economies: The Ongoing Story*. The new Privatization Law also incorporated recommendations from Legal and Regulatory Framework Assessment for Public Enterprise Restructuring Program prepared by Bank Team which identified potential legal, regulatory and resource constraints that may hinder or delay timely completion of the divestiture program and made specific recommendations, notably with respect to amendments to the legal framework. Finally, a study assessing the framework for dealing with environmental liabilities in the privatization process, pointed out to the need to further strengthen the administrative and implementation capacity for addressing environmental liabilities. It recommended in particular, with respect to the restructuring and disposition program: to update the environmental assessments where deemed necessary; to include clear provisions in the restructuring agreements of how environmental liabilities will be handled and conditions under which government resources would be used for remediation; to improve coordination between the Privatization Agency and the other competent authorities with respect to preparation and compliance monitoring of environmental action plans agreed upon for the disposition of companies in restructuring. (See *Report on analysis of policy, regulatory and implementation framework for addressing environmental liabilities in privatization in Republic of Serbia*, World Bank, June 2013, Milieu, Law and Policy Consulting).
Pillar B **Strengthening governance regulatory and institutional framework, and monitoring and transparency arrangements**
Prior action #4: For the 24 Public Enterprises for which the Republic of Serbia is the founder, and subject to the Law on Public Enterprises: adopt new Statutes and Founding Acts and appoint the supervisory boards in at least 15 of them; and establish audit committees in line with new legal environment in at least 10. **Prior action #6:** Establish quarterly business monitoring as provided for under Article 52 of the PE Law and Decree for Template on Quarterly Reporting on fulfillment of annual plans of Public Enterprises and their subsidiaries (published in Official Gazette 36/13 and amended in Official Gazette 27/14).
Analytical Underpinnings: The prior actions are informed by a note prepared by the Bank team which, building on the OECD Guidelines on the Corporate Governance of State-Owned Enterprises and the experience of comparable countries in undertaking governance reforms, examines Serbia's corporate governance frameworks and practices for state-owned enterprises (SOEs) and offers policy recommendations for improvement.
Prior action #5: Public Oversight Board for Auditing in the Republic of Serbia has been established pursuant to the Law on Auditing, and is fully operational, conducting public oversight of the quality of performance and operations of the audit profession in Serbia, in line with the Law, by, inter alia, issuing opinions, making recommendations and proposing corrective measures.
Analytical Underpinnings: The new laws introduce international standards and translate the *Acquis Communautaires* taking into account the experiences of other Western Balkans countries that have successfully

completed these reforms. They were prepared with support from the Road to Europe: Program for Accounting Reform and Institutional Strengthening (REPARIS) program.
Pillar C - Mitigating the social and labor impact of the SOE reform program
Prior action #7: Adopt the governmental decree confirming and detailing the options and amounts for the social programs to be paid out in 2015. Provide sufficient funding (at least RSD 16 billion) in the Budget 2015 for financial compensation needed to mitigate the social impact of the disposition of companies in restructuring.. **Prior action #8:** Include in the 2015 performance agreement of the National Employment Service (NES) with the Ministry Labor, Employment, Veterans and Social Affairs, a requirement for NES (i) to visit every company that plans to lay off more than 10 workers and inform workers about available NES services, programs, and benefits, register them with NES, and develop an individual action plan for each registered redundant worker; (ii) to contact at least 20 employers in the same and neighboring municipalities where the company resides to offer them NES services and inquire about job vacancies; and (iii) to consult with the local employment council about support for redundant workers.
Analytical Underpinnings: The Poverty and Social Impact Assessment prepared for this operation underscored the critical importance of severance packages in supporting redundant workers. In addition to the importance of severance packages, the PSIA pointed out that many redundant workers fail to transition into new jobs and highlights a critical gender angle to it. This suggests the importance of programs to support redundant workers in their job search efforts, like job search counseling, re-training, and, as a measure of last resort, public works. As part of the ongoing technical assistance on jobs, the team has carried out an assessment of current ALMPs and the capacity of the NES to deliver these programs and found sufficient evidence to support the current programs and the NES.

C. LINK TO CPS AND OTHER BANK OPERATIONS

58. **The proposed DPL series is fully congruent with the Country Partnership Strategy (CPS) for FY12-15 and will contribute to both of its strategic pillars (Pillar 1: “Strengthening competitiveness” and Pillar 2: “Improved Efficiency and Outcomes in Social Spending”).** Pillar 1 aims in particular at restoring strong, sustainable and job-creating growth through improved competitiveness by reforming non-private enterprises, investments in road rehabilitation, reform of the judiciary, and innovation. It builds on previous Bank’s efforts to support Serbia’s transition to a market economy, including the Private and Financial Sector Structural Adjustment Credit series (2003-2004), a Programmatic Private and Financial Development Policy Credit (2005), a Programmatic Private and Financial Development Policy Loan series (2008-2010), and Private and Financial Sector Policy Based Guarantee (2011).

59. **The implementation of the proposed operation will be directly supported and complemented with various TA and capacity building activities.** Such activities include: (i) separate Competitiveness and Jobs results based loan, currently under preparation and expected to be presented to the Bank Board during the 2015 calendar year, which will include support to the National Employment Service, redesign of ALMPs and reforms, redesign of social benefits to encourage formal work for types of workers likely to be made redundant as part of the SOE reforms, as well as broader set of reforms to enhance Serbia’s competitiveness and improve demand for labor; (ii) the Road to Europe: Program for Accounting Reform and Institutional Strengthening (REPARIS) program, funded by the Governments of Austria, Luxembourg and Switzerland, supporting financial reporting and audit reforms, as well as follow up TA on corporate accounting and audit provided by CFRR which will feature a separate component on SOEs; (iii) a technical assistance program, co-financed by the European Commission, supporting the preparation of Serbia’s Employment Strategy and the development of a comprehensive, actionable, and budgeted roadmap to foster job growth in Serbia; (iv) an IFC technical assistance program on strengthening the capacity and enhancing the legal framework for insolvency and debt resolution.

D. Consultations, Collaboration With Development Partners

60. **The government's reform program supported by the DPL series has benefitted from extensive consultations with relevant stakeholders.** The preparation of the legal changes introduced under the program included extensive public consultations, including for the new laws on public enterprises, accounting, and auditing, as well as the amendments introduced to the privatization legal framework. The reform program for disposition of PA portfolio was adopted after several rounds of intensive consultations – including the last one which took place between October 2013 and July 2014 and led to the adoption of the new legal framework mapping out the process. These consultations took place between relevant government representatives – including MoF, MoE, and MoELVSA – and union representatives, civil society, business associations, and development partners. This reform program was also at the core of government's pre-election program and discussed during the spring 2014 elections campaign.

61. **In addition, the World Bank team has collaborated and consulted closely with other Development partners and domestic stakeholders, including the IMF.** This consisted of regular exchange information and participation in joint meetings with technical counterparts, which contributed to design the reform program. The Bank also held consultations with stakeholders, including unions, business associations, and non-government organizations' representatives, notably with respect to the outcome of the Poverty and Social Impact Analyses and the resulting implications for the design of social impact mitigation measures.

V. OTHER DESIGN AND APPRAISAL ISSUES

A. Poverty And Social Impact

62. **The improved performance of the public enterprise sector and the reduction of the direct and indirect subsidies channeled to this sector are expected to foster sustainable economic growth and job creation, albeit there will be job losses in the short run.** Poverty reduction and shared prosperity in Serbia has closely mirrored economic growth, with substantial progress achieved before the global financial crisis and deterioration since the crisis. Reinvigorating economic growth is therefore necessary—although not sufficient—to make progress towards the twin goals. In addition to growth, reducing poverty and boosting shared prosperity will require creating broad-based income-generating employment opportunities for the people, a long-standing impediment to a sustainable improvement in welfare of the less well-off in Serbia. Overall, the sluggish progress on both growth and poverty reflects a largely unfinished first-generation reform agenda toward a vibrant private sector and an efficient public sector. It also underscores the significant challenges that Serbia faces in generating income opportunities for those at the bottom of the distribution and excluded groups. In the short run, the reforms supported by the series will result in job losses. The authorities estimate that for the 140 which were in restructuring as of August 2014 up to 30,000 jobs (out of total of 55,000) could be lost. The progressive divestiture of the remaining companies in the PA portfolio (374 companies representing about 35,000 jobs) is not expected to result in massive job losses, as those companies already operate on a commercial basis and without significant state support. Finally, the introduction of the performance criteria under Pillar B might also result in longer term adjustments

in the workforce of utilities and other companies to which those criteria are applied, albeit those impacts will not manifest themselves and cannot be monitored over the life span of this DPL series.

63. **Given the difficulty to estimate the overall poverty impacts of the series, the PSIA focused only on the likely welfare impacts of the anticipated job losses on those affected and the appropriateness of the compensation measures included in the social pillar.** The assessment (cf. Box 1 for a description of methodology and data sources) concluded that given the profile of workers currently in the PA portfolio the impact of job losses on households is likely to be significant and called for a strengthening of the mitigation mechanism in place in the past. The assessment underscored in particular that:

(a) **Workers in the PA portfolio are likely to be difficult to reemploy.** Workers who were dismissed as part of previous privatizations have had great difficulties in finding new jobs, particularly if they were older, low skilled and living in areas which had been greatly dependent on state owned firms as employers. The profile of the workers currently in the PA portfolio matches those characteristics (they are older and low skilled – 46 percent of them has lower secondary or less) suggesting it is unlikely that they will find jobs, particularly in the current economic climate. Workers in the PA portfolio currently report worse indicators of job quality than other SOE workers (reporting a higher likelihood that their pensions and health insurance contribution or that their wages are not paid, as well as being concerned that in the future they will not be paid wages or lose their jobs) yet they are less likely to look for other jobs. In addition, in some areas of the country the distribution of workers employed in firms in the PA portfolio is rather concentrated geographically, which could compound the challenges dismissed workers face in finding new employment if large layoffs are implemented in those areas.

(b) **The majority of dismissed workers appear likely to end up as occasional laborers in the informal sector.** Most of these jobs are very seasonal. Women might be able to have jobs such as taking care of elderly or cleaning, which are in more steady demand throughout the year but that pay less. Beyond these monetary impacts, the qualitative work also highlighted how households were put under different types of pressures by the redundancies, such as by inducing depression and isolation in some dismissed workers who lost their sense of belonging and purpose, and who due to monetary pressures could not socialize in customary ways. These broader effects in some cases spilled over on the household as a whole, resulting in increased tensions. In this respect, women appeared to have coped better than men, as they tended to have more extensive social networks even after job losses.

(c) **Despite the existence of a "premium" for working in the SOE sector as compared to the private sector, workers in the PA portfolio enjoy smaller premia and on average are not particularly well off in terms of savings or alternative income sources.** Part of the vulnerability to falling into poverty after a job loss depends on the asset structure of the household, with factors such as their earning potential, their ability to save, and how likely other sources of income might help them make up for the job they lost playing a key role. Indicators of these different profile show that PA SOE workers are not as well off in general, as well as with respect as other SOE workers. Unlike other SOE workers, who are more represented in the higher income groups, PA SOE workers are distributed uniformly across income groups. And while wage analysis reveals that there is a "premium" in working in SOEs with respect to the private sector, it is lower for PA SOE workers. The share of PA SOE workers reporting to be able to save out of their income is higher than in the private sector, but it is only 12 percent. And a rough indicator of earning potential of the household (the household average of the years of schooling of working age members) shows that for PA SOE households it is lower than for both other SOE and the private sector. On a more positive note, one in five PA SOE workers reports to have some land that could be used for agricultural purposes, and which could therefore allow them to cut down on food expenses or to put in place small scale productive activities.

(d) **The main compensation mechanisms used under previous privatization was financial compensation under the Transition Fund, and such measures are mostly meant to help cushion the shock of temporary unemployment, until the workers find a new job. Further, passive programs were underfunded in the past and likely to result in significant disparities between workers in different categories, while the effectiveness of active measures has been limited.** Workers who received compensation in the past used it to pay off debt and pay for household daily expenses, but the impact of severance payment on households' budgets did not last long. Similarly, workers in the PA portfolio mostly plan to spend their severance to finance household consumption. Active labour market programs do not seem to have been very effective in helping people finding jobs. The main value to workers of the NES is guaranteeing their access to health insurance. While some workers are aware of useful services provided by the NES (most of them do not know), they tend to consider themselves too old to benefit from training. The NES does not appear to be able to provide them with job offers of any kind (even for jobs which require lower skills than they have). Even programs that appeared to be promising in helping individuals find jobs, appear to have been less successful than expected. The subsidy for self-employment, for example, seems to have helped informal enterprises legalize for a while, but once the support was over those firms reverted to informality. Finally, other types of support measures such as Social Assistance, are too small and have too tight eligibility thresholds to benefit any significant proportion of the households which would be affected by the privatization effort.

(e) **Another important finding of the assessment is that, while the majority of those interviewed hold very negative views on the impact of privatization on the livelihoods of those who were made redundant in the past, there seems to be a fair amount of uncertainty or lack of information around the process of redundancy and workers' rights.** In different group discussions held as part of the PSIA uncertainty about pension rights emerged as a strong concern, particularly given the context of a rising retirement age. Similarly, respondents did not have a clear sense of which types of services the NES can deliver, even if some reported that services such as training would be good "for young people" (defined as being less than 35). And lack of clarity seems to characterize also workers' expectations in terms of severance. When asked about what determines the amount of severance they are going to receive, 50 percent of PA SOE workers believed that it is dictated by existing regulations. About one third, however, sees it as depending on "negotiations" or "politicians". The emphasis on negotiation might reflect the real experiences of well-publicized cases where workers obtained significantly more than their statutory rights from the Transition Fund. The role of those cases in anchoring expectations cannot be dismissed: when asked about hypothetical scenarios on severance, 28 percent of respondents declared that they would not take packages which they viewed as too low it even if this were the only option and available only for a limited amount of time. A different type of uncertainty around process emerged in discussions on previous redundancy processes. Some workers reported that communication with management over the process was often poor, so that, despite signs that the business was having problems their redundancy took them by surprise. This made their households less able to adjust to the sudden income loss. The problem appears to have been even more severe for workers that saw their firm suddenly go bankrupt. Other workers also reported feeling "cheated" of their rights by management, as they were asked to sign papers that gave away their rights to severance or to past wages. It has not been possible to ascertain whether those were instances of truly fraudulent behavior or some procedural requirement which the workers did not fully understand, such the requirements of applying to the Solidarity Fund for which workers sign off their claims on the bankruptcy proceedings in favor of the Fund.

64. **The measures supported under the social pillar of this DPL series are expected to help cushioning the poverty and social impact of the project.** The authorities are committed to provide redundancy packages to all redundant workers affected by the resolution of the PA portfolio. In addition, a targeted expansion of NES services might help improve their relevance to the needs of the workers in the SOE portfolio, particularly younger ones. It is however the measures supported under the second operation in the DPL series, and which should become operational by the time the largest employment impacts are to be expected, which are likely to help the most in addressing the negative impacts of the PA portfolio resolution. The direct provision of employment opportunities through public work programs, and the reduction of some of the disincentives to employment creation are expected to address the main factor behind the negative experiences of those who were made redundant in the past, namely their inability to find jobs. While neither of those interventions can compensate a job loss, workers in the PA portfolio have already seen the quality of their employment slip, and many appear focused on receiving a fair severance payment, and finding a temporary solution which can bridge them over to retirement.

Box 1: Methodology and data sources for this PSIA

This PSIA was conducted with an explicitly multi-disciplinary approach to capture the complex set of impacts to be expected, and with a particular emphasis on exploring gender differences. By combining the review of existing evidence, with the collection of new qualitative and quantitative data the team sought:

(i) to collect information on the individual characteristics of the workers likely affected by the measures supported by the operation and of their livelihoods (the number and type of workers in different categories, and their gender, age, skills and welfare profile). This information was collected by relying on (a) administrative data on the characteristics of the workers in the Privatization Agency (PA) portfolio; (b) detailed information from the Labour Force Survey (LFS); (c) a special module that was administered in November 2011 to all employed workers in the LFS sample; (d) information from an additional sample constituted of workers from firms currently in the PA portfolio.

(ii) to map the impacts (broadly defined) of job losses on households investigating, for example, changes in labor market participation of other household members, their possible consequences on gender dynamics within the household, etc. To explore these issues, a set of 18 focus groups conducted with workers who were dismissed in previous privatization efforts and their household members (separately interviewed), and stratified in terms of gender of respondents and by location (mono-industrial cities versus more economically diversified environments) were conducted.

(iii) to evaluate ex-ante the effectiveness of existing and planned policy responses taking into consideration the needs and preferences of workers with different characteristics (e.g. gender, age etc.). This involved relying on a number of pieces of information, including the coping strategies information from the Focus Group discussions, specific sets of questions administered to all employed in the LFS and to the special sample of respondents from the PA portfolio, and a set of special in-depth interviews to complement the quantitative findings of the evaluations of two different programs (the Severance to Job program and the Subsidies for Self-Employment program). And

(iv) to create a baseline for monitoring of the operation's impacts in the future, possibly by aiming to interview the same set of workers in the future and construct a panel. Despite our best efforts to increase the response rate from the sample of workers drawn from the PA portfolio, this fourth objective could not be fully achieved. Future efforts to monitor the impact of the operation as it is been implemented will require designing a different strategy for tracing workers, being mindful of the risks of high non-response rate experienced thus far.

Source: Addressing the Poverty, Gender and Social Impacts of Privatization in Serbia, Draft March 2013

65. **The measures under the social pillar are also expected to address certain gender impacts and inequalities.** First, the PSIA found that the gender differences that were identified in terms of impacts of redundancy or overall vulnerability mostly relate to cultural norms and expectations on men being traditionally the bread winners. Different parts of the focus group discussions probed participants to reflect directly or indirectly on gender differences. While both older workers of either gender face difficulties in finding new employment, men appear to be more likely to feel despondent for the loss of their role as a breadwinner. Women, while traditionally in charge of administering household finance, and aware of the difficulties in facing different types of expenses that follows redundancy, overall appeared to be more resourceful in terms of identifying small scale activities to supplement family income, and more likely to adapt to their changed circumstances by continuing to engage in their traditional roles as home makers and

primary care takers for their family members. Redundancy and the way the impacts of the jobs loss were faced by either gender were seen as leading to increased tension in the household. This negative social impact, which seems to particularly affect men (who also represent a larger share of employees losing jobs), will be mitigated by the set of measures previously described to cushion poverty impacts. Second, the efforts to assess and remove disincentives to formal employment for women and open up economic opportunities for them, as they are overrepresented among part-time workers, should contribute to generate further employment opportunities.

B. Environmental Aspects

66. **Overall the reform policies supported by the DPL series are not likely to have significant adverse effect on the environment, forests and natural resources.** Key policies for disposition of companies in the Privatization Agency portfolio supported under Pillar A, are in place, including the general provisions for addressing environmental damage prior to privatization. The Government is committed to elaborate further on the regulatory requirements and responsibilities for past environmental liabilities in the Law on Environmental Liabilities which is under preparation. Strengthening further the legal and institutional framework that accompanies the divestiture of assets and capital, with measures for properly handling legacy environment liabilities incurred by SOEs, will ensure that the proposed DPL series are in compliance with OP 8.60.

67. **Serbia has made progress towards alignment of its policies with the European Union environmental acquis. At the same time further effort is needed to strengthen the administrative capacity and implementation framework for management of environmental risks while addressing environmental damage caused by past industrial operations.** The Privatization Law establishes that resources for addressing environment legacy liabilities prior to privatization shall be provided in the budget (Article 83). The new Law also introduced specific provisions for the assets sale model, which require that the assets sale program governing the transaction contains an environmental protection program (Article 50) 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. 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/ i.e. damaging the natural environment is liable - including in the case of liquidation or bankruptcies – and that the polluter or its legal successor is responsible for eliminating the cause of pollution and related direct or indirect consequences. Although practices in Serbia vary and are not always consistent with regulatory provisions for environmental protection, it expected that in the process of change of ownership of companies or of ownership structure, the process shall include an assessment of environmental damage and allocation of liability before the conclusion of privatization deals especially for industries from metallurgical, chemical, pharmaceutical machine- building, transport, energy, food processing sectors, including settlement of debts of the ex-owner for pollution or damage to the environment. The LEP also sets conditions for monitoring and control of environmental impacts from on-going industrial operations, including emission limit values and safety working conditions. In case of breach of emission limit values or other activities causing risks and degradation of environment, the polluter is obliged to develop and

implement a rehabilitation plan and pay for incurred expenses. The Law on Environmental Liabilities (LEL), which is under preparation will be in line with the EU Directive 2004/35/EC of 21 April 2004 (Directive on environmental liability with regard to the prevention and remedying of environmental damage). The adoption of LEL will guarantee that in privatized or liquidated SOEs the preventive and remedial actions to address past damage to environment will be undertaken to eliminate the risk of negative impact on human health and environment. Currently the Privatization Agency does not have staff assigned for overseeing the implementation of regulatory provisions for assessment of environmental damage or internal guidelines for implementation of the LEP provisions for environmental liabilities.

68. **The 2010 National Environmental Approximation Strategy provides for the establishment of a working group to determine how to transpose and implement the EU environmental legislation including the Environmental Liability Directive (ELD).** The preparation of a Specific Implementation Plan and the adoption of amendments to the LEP and Law on Nature Protection and by-laws are scheduled for the end of 2014. The environmental permitting process is the key instrument used to ensure that companies comply with environmental regulations. It is regulated by the Integrated Pollution Prevention and Control (IPPC) Law according which all installations - but for energy, waste management and mineral industry installations - were required to submit applications for IPPC permits by 2013; the deadline for the remaining installations is March 2014. Applications for IPPC permits contain, inter alia, a plan of measures for environmental protection following the closure of the installation and cessation of activities. The permitting process is also used to identify any significant instances of past environmental damage on company's site. Compliance with the IPPC Law for privatized entities would be a litmus test for the effectiveness of regulatory enforcement.

69. **Serbia's privatization program has taken a number of progressive measures to address the environmental liabilities of entities undergoing privatization.** Recognizing that strategic investors would be reluctant to invest or would discount their offer prices if there are significant unassigned environmental liabilities, the Privatization Law was amended to establish that the liability for environmental damage caused by a socially or state-owned enterprise up to the date of privatization rests with the State. The effective handling of environment liabilities in privatization process which relies on the environment assessments, privatization agreements, and environmental action plans to address environmental concerns. The procedure and content of the environmental assessments vary greatly, with more detailed environmental assessment carried out only where a preliminary review of the information revealed the presence of problems. Out of the 140 companies which were in restructuring as of August 13, 2014, 71 have specific environmental assessments – including 31 detailed ones funded by the World Bank or the EU which incorporate proposals for environmental improvements together with cost estimates. Specific environmental assessments were not deemed necessary for the remaining companies. A review of a sample of privatization agreements confirms that contractual provisions addressing environmental issues were included. The principle of legal successors' liability provided for in the LEP was applied by default. In a few cases, generally when foreign investors were involved, the provisions of the Privatization Law for assigning past environmental liability to the State were implemented, albeit with specific case by case limits. The review of past privatization deals of selected enterprises also revealed deficiencies on adherence to environmental action plans and post-privatization reporting. The capacity of the PA to oversee and manage the environmental assessment process has declined.

70. **For the completion of the divestiture of the Privatization Agency portfolio as provided for in the Privatization Law, the World Bank recommends to further strengthen enforcement and implementation with regards to environmental damage liability provisions of the law by adopting the Law on Environmental Liabilities.** The authorities should in particular: (i) complete the updates and environmental assessments for industries from the key sectors associated with significant environmental risks and poor environmental performance which will provide the scale and cost of environmental damage; (ii) include clear provisions in the restructuring agreements of how environmental liabilities will be handled and conditions under which government resources would be used for remediation; and (iii) improve coordination between the Privatization Agency and the other competent authorities with respect to preparation and compliance monitoring of environmental action plans agreed upon for the disposition of companies in restructuring.

C. PFM, FUNDS FLOW AND AUDITING ASPECTS

71. **The assessment of adequacy of the country's public financial management 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 Public Expenditure and Financial Accountability (PEFA) assessments which have been conducted in 2010, and the one from 2014 (still ongoing). It also takes into account relevant chapters of EU Progress Reports, annual SIGMA assessments of public expenditure management and public internal financial control. Note is also taken of in-country reports, such as those published 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.

72. **Significant reforms have been undertaken to strengthen public financial management system, with several areas requiring further improvements.** The reforms resulted in notable improvements in the effectiveness of the treasury system, including the establishment of improved financial control and accountability arrangements and increased transparency in public finances. Single Treasury Account exists and it operates well, thus enabling much improved cash management. The government brought into the budget and/or closed a number of extra budgetary funds. Nevertheless, budget preparation faces issues repeatedly vis-à-vis the process and its timeliness. There were efforts to reduce arrears in the public sector by introducing a new law on payment deadlines and improved system of commitment control within the Treasury. Annual financial statements are prepared on cash-basis of accounting, with parallel shift to accrual basis planned in the medium-term, which is expected to improve information on assets and liabilities.

73. **Gradual strengthening of the control framework towards implementation of Public Internal Financial Control (PIFC).** While the 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 majority of public sector entities and further efforts are needed in increasing its effectiveness. 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 2013 annual financial statements of the Government, and issues identified in previous years persist, mostly with major areas for improvement being lack of appropriate systems of internal controls, deficient information on assets and compliance with public procurement law, although reduced number of recommendations in relation to lack of compliance with the said law is noted.

74. **Improved management of public finances will require shift from annual to strategic and forward looking approach.** Medium term budgeting exists for three years on a rolling basis, but in reality budgets are executed without appropriate consideration of the two following years. Planning and management of capital investments will need to be based on more precise and meaningful cost-benefit analysis in order to enable efficient use of resources and yield better results. Meaningful sector strategies should exist, which include full costing of recurrent and investment expenditures.

75. **The independent assessments of PFM performance suggest that the fiduciary risks associated with the PFM system in Serbia are substantial with the reforms proving to be effective.** The ongoing improvement in the treasury system, internal audit and external audit through SAI is encouraging and is strengthening the transparency, accountability and control framework within Serbia.

76. **The control environment and procedures applied in the NBS and the Treasury are considered adequate.** As per the World Bank's assessment of the 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. IMF Safeguards Assessment (2011) found that the NBS safeguards framework had been considerably strengthened and the quality of financial statements and internal audit had improved markedly. Key recommendations include strengthening external oversight of NBS operations and amending the NBS law to increase operational and financial independence. Annual independent financial audits of the NBS do not identify any significant issues either. The auditors (Deloitte) issued clean (unmodified) opinion on the NBS financial statements for 2013. 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.

77. **Borrower and Loan Amount.** The Borrower is the Republic of Serbia. This operation is a single-tranche loan. 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 was included in Law on Budget for 2015.

78. **Funds flow.** 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 International Bank for Reconstruction and Development (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 government's budget system.

79. **No audit of the deposit account will be required, but rather a confirmation letter to be provided.** The MoF will provide IBRD with a 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 is required of receipt of the loan proceeds. No additional arrangements to mitigate fiduciary risks, such as audit, are required as the disbursement arrangements are confined to the NBS and Single Treasury Account.

D. Monitoring And Evaluation

80. **The Ministry of Economy and Ministry of Finance will be 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 Economy and Ministry of Finance, key entities directly responsible for implementing the supported program include the Ministry of Labor, Employment, Veteran and Social Affairs, and the Privatization Agency. The quarterly reporting mechanism for public enterprises established by the Law on Public Enterprises ensures timely and detailed information on both financial performance and possible fiscal risks is available to the Ministry of Economy and Ministry of Finance. The resolution of the Privatization Agency portfolio will be monitored primarily by the case workers from the PA assigned to individual companies. The data collected by the PA allows the Ministry of Economy to have a strategic overview of the overall process. The National Employment Service already has in place solid data collection mechanisms and reach data bases both on the unemployed and on the ALMPs implemented. The data system and analytical capacity in the NES are being further strengthened with the support of a separate Bank operation on Competitiveness and Jobs.

81. **The World Bank will monitor the status of the project implementation through the supervision missions and by tracking the output indicators.** As part of the monitoring and evaluation process, the World Bank will track the baseline and output indicators provided in the policy and results matrix (Annex I) based on the economic and legislative data provided by the government agencies and disclosed in the official sources. The World Bank team will conduct supervision visits in the country to maintain the dialogue with the authorities and to assess the compliance of the authorities with contractual provisions under the loan agreement. The outcomes of the supervision visits will be reflected in the Implementation Status Reports (ISRs). An Implementation Completion Report (ICR) will be completed within six months of the closing date of the project.

82. **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 http://www.inspectionpanel.org.

VI. SUMMARY OF RISKS AND MITIGATION

83. **Overall risk rating for this operation is high.** While there is a broad consensus that the supported reforms are needed and overdue, they will undermine entrenched interests in the short run while the expected benefits will be delayed and more diffused. The risk of rising social and political pressures calling for halting or reversing the reform is substantial. The overall and political risk is mitigated by the overarching strategic objective and aspiration of Serbia to furthering economic integration with the European Union which calls for an acceleration of the structural reforms. This is further reinforced in the recent Serbia Progress Report (from October 2014) by the EC, which highlights the need to implement wide range of structural reforms including: reducing the heavy state influence in the economy, tackling inefficiencies in the large public sector, advancing privatization in line with the schedule, streamlining state aid, and improving corporate governance of public companies. The operation supports strengthening of governance and institutional framework for SOEs, including strengthening the selection of high level management positions. However, even the most transparent and competitive process cannot eliminate the risk that the selected candidates end up involved in improper activities. With respect to social risks, the series includes a pillar specifically dedicated to mitigate the social and employment impact of the program. Finally, the Bank will also support the authorities in communicating the benefits of the proposed reforms to preserve political momentum for the reform program.

84. **There are substantial external and internal macroeconomic risks.** External risks are related to possible delays in Europe's overall economic recovery, which could hamper Serbia's growth through their adverse impact on exports, remittances and capital flows. Revenues could be lower than expected if the external slowdown is translated into lower domestic demand. External economic developments and the pace of economic recovery in the key export markets is both uncertain and beyond the control of the authorities. A deterioration of the financial situation of foreign parent banks could similarly jeopardize credit recovery and undermine growth. Internal risks to the fiscal framework arise from: (i) the difficulty to circumscribe the issuance of new guarantees, especially to natural gas monopoly Srbijagas; and (ii) a failure to reduce subsidies as intended. If some of these risks were to be realized, the government would need to undertake even greater fiscal consolidation efforts in 2015 and 2016 to ensure that public debt remains sustainable. This risk will be mitigated by a close monitoring of economic and fiscal developments, and by the fact that the framework is supported by the IMF (the IMF Board approved a Stand-By Arrangement (SBA) program on February 23, 2015). These risks are further mitigated by WBG comprehensive engagement in Serbia, including on public sector reform

85. **Implementation risks are substantial.** Implementation of the proposed program will strain the capacity of public sector institutions directly involved, in particular the Privatization Agency, the National Employment Services of the Ministry of Labor, Employment, Veteran and Social Affairs, the units in Ministry of Finance and Ministry of Economy responsible for SOE oversight, and the courts handling bankruptcy cases. This risk will be mitigated by various

envisaged technical assistance programs – including technical assistance provided in the context of the mid-term review of Serbia's Employment Strategy – as well as by continued implementation monitoring.

86. **Overall financial management risk to Bank development policy lending funds is substantial.** The FM risk is based on pre-determined country financial management risk, not related to stand alone assessment of this operation only. The country risk is mitigated by the fact that most reliable parts of the PFM system are used for implementation of the DPL (ie. Treasury and NBS). The assessments of PFM performance acknowledges progress from ongoing reforms and identifies areas needing further strengthening, including with respect to transparency, accountability and control framework to mitigate the fiduciary risks associated with the PFM system in Serbia.

87. **Environmental risk is moderate.** A review of policies, regulatory and implementation framework indicates that in the past a number of progressive steps were taken to address environmental liabilities of entities undergoing privatization. However, current practice shows that these measures are not applied consistently and their impact has been mixed. The authorities confirmed that the environmental assessment for the companies in restructuring will be updated and completed for at least 180 SOEs as required before their disposition. Similarly, the new Law on Environmental Liabilities will elaborate further on the responsibilities and financing for handling environmental liabilities, Finally, PA's capacity for oversight on the implementation of action plans and post-privatization compliance reports for companies to be divested under the current Privatization Law will be strengthened.

Table 5. Systematic Operations Risk Rating Tool

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

ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions and Triggers		Results
Prior Actions under DPO 1	**Indicative Triggers for DPO 2**	
Pillar A- Accelerating the restructuring and divestiture program for Privatization Agency Portfolio and selected State Owned Enterprises operating in the commercial sector ***Program Development Objective A- Reduce State participation and levels of direct and indirect state support in the real sector***		
Prior action #1: Enact a new Privatization Law, and amendments to the Bankruptcy Law and Privatization Agency Law to facilitate and accelerate the disposition of Privatization Agency portfolio	**Trigger # 1:** Out of 140 PA companies that were in restructuring as of August 13, 2014, at least 100 have been resolved.	**Result Indicator A1**—Reduction of direct and indirect support to companies in Privatization Agency portfolio: - Annual direct subsidies and soft loans (million Euro): o Baseline (average 2010-2012): 85 o Target (2015): less than 10 - New taxes and social contribution arrears: o Baseline (average 2010-2012): 190 o Target (2016): less than 20 - New arrears to public utilities: o Baseline (average 2010-2012): 70 o Target (2016): less than 20
Prior action #2: Adopt Decisions on method, models, and measures for at least 140 PA companies to be resolved using the capital sale or asset sale model and for 19 micro PA companies; and Adopt the Action Plan for the 188 PA companies to be resolved through bankruptcy	**Trigger # 2:** For PA companies that were not in restructuring as of August 13, 2014, public bids were announced for at least 20 PA companies. **Trigger # 3:** Ministry of Agriculture and Environmental Protection has assessed the potential environmental damages for at least180 PA companies - including those in bankruptcy for which the PA is the bankruptcy administrator - and prepared a report on scale of environmental damages and initial cost estimates for addressing such liabilities in all of those PA companies where potential environmental damages were identified.	
Prior action #3: The Borrower has launched the implementation of the new Privatization Law: (i) initiation of bankruptcy procedures, through letters from the Privatization Agency to the relevant commercial courts for 76 PA companies with no employees; (ii) public bid announced, under the equity or asset sale model, for at least two PA companies that were in restructuring as of August 13, 2014; (iii) Programs for asset sales delivered to the PA by at least eight PA companies, that were in restructuring as of August 13, 2014; (iv) Government adopts a decision on a strategic partnership for at least two PA companies.		

<table>
<tr><th colspan="3">Pillar B - Strengthening governance regulatory and institutional framework, and monitoring and transparency arrangements
Program Development Objective B - Improve performance and accountability of state owned enterprises</th></tr>
<tr><td>Prior action #4: For the 24 Public Enterprises for which the Republic of Serbia is the founder, and subject to the Law on Public Enterprises: adopt new Statutes and Founding Acts and appoint the supervisory boards in at least 15 of them; and establish audit committees in line with new legal environment in at least 10.</td><td>Trigger # 4 Adopt the legal framework on accountability mechanisms indicated in the PE Law for dismissal of General Managers and Board members and the introduction of performance bonuses.</td><td rowspan="3">Result Indicator B1 - Audited financial statements prepared and published by public enterprises required to do so by the Law on Public Enterprises and new Law on Accounting and Law on Auditing for all Public Enterprises for which the founder is the Republic of Serbia – Baseline (2012, none); Target (2015 audits published in 2016, all required).

Result Indicator B2—Reduction of direct subsidies and reduction of issuance of new guarantees for liquidity purposes for large SOEs:
- Direct subsidies (million Euro)
o Baseline (average 2012-2014): 250
o Target (2015): less than 200
- Annual guaranties for liquidity purposes (million Euro):
o Baseline (average 2012-2014): 265
Target (2015): less than 100 million</td></tr>
<tr><td>Prior action #5: Public Oversight Board for Auditing in the Republic of Serbia has been established pursuant to the Law on Auditing, and is fully operational, conducting public oversight of the quality of performance and operations of the audit profession in Serbia, in line with the Law, by, inter alia, issuing opinions, making recommendations and proposing corrective measures.</td><td>Trigger # 5: Adopt legal framework to ensure full congruency so that corporatized SOEs are adequately monitored and maintain high standards of transparency and disclosure.</td></tr>
<tr><td>Prior action #6: Establish quarterly business monitoring as provided for under Article 52 of the PE Law and Decree for Template on Quarterly Reporting on fulfillment of annual plans of Public Enterprises and their subsidiaries (published in Official Gazette 36/13 and amended in Official Gazette 27/14).</td><td>Trigger # 6: Establish audit committees in all Public Enterprises for which the founder is the Republic of Serbia and are subject to the Law on Public Enterprises.</td></tr>
</table>

Pillar C- Mitigating the social and labor impact of the SOE reform program ***Program Development Objectives C1 - Ensure adequate financial protection of redundant workers of non-private enterprises, and*** ***C2 - Facilitate transition into employment and provide employment opportunities for vulnerable redundant workers.***		
Prior action #7: Adopt the governmental decree confirming and detailing the options and amounts for the social programs to be paid out in 2015. Provide sufficient funding (at least RSD 16 billion) in the Budget 2015 for financial compensation needed to mitigate the social impact of the disposition of companies in restructuring.	**Trigger # 7:** The design and targeting of public works is improved so it can better act as an additional safety net for vulnerable groups, including redundant workers.	**Result Indicator C1:** Number of redundant workers receiving compensation from the Transition Fund increases from approx. 5,700 (2014) to at least 10,000 (2015) (to be monitored by gender) **Results Indicator C2:** At least 30 percent of workers made redundant from public enterprises during 2015 register with NES (to be monitored by gender). **Result Indicator C3:** Number of participants in public works increases from 2,882 in 2013 (1,187 female and 1,695 male) to at least 6,000 in 2015 (to be monitored by gender).
Prior action #8: Include in the 2015 performance agreement of the National Employment Service (NES) with the Ministry Labor, Employment, Veterans and Social Affairs (signed on February 11, 2015) a requirement for NES: (i) to visit every company that plans to lay off more than 10 workers and inform workers about available NES services, programs, and benefits, register them with NES, and develop an individual action plan for each registered redundant worker; (ii) to contact at least 20 employers in the same and neighboring municipalities where the company resides to offer them NES services and inquire about job vacancies; and (iii) to consult with the local employment council about support for redundant workers.	**Trigger # 8:** The MoF, MoE and MoLEVSA will assess the impact of the existing social security regime on the labor market and propose measures to Government to remove disincentives for formal employment opportunities for low–paying part time work and self-employment, taking into account the medium term macro fiscal framework.	

ANNEX 2: LETTER OF DEVELOPMENT POLICY

Republic of Serbia
MINISTRY OF FINANCE
No: 337-00-84/2015-24
February 23, 2015
20 Kneza Miloša St.
B e l g r a d e

Dr. Jim Yong Kim, President
The World Bank
1818 H Street, N.W.
Washington, D.C., 20433

Subject: Letter of Development Policy
Republic of Serbia: Loan for Development and Restructuring of Enterprises in the Republic of Serbia (SOE-DPL)

Dear Mr. Kim,

This letter summarizes in a selective manner critical aspects of the program that the Government of the Republic of Serbia is committed to undertake over the short and medium term to implement structural reforms of the state owned enterprise sector. The aim of the program is to improve the governance, transparency and accountability of SOEs that will remain in government ownership, restructure and divest from non-competitive enterprises, reduce fiscal burden imposed by the 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.

Macroeconomic framework

The Government of the Republic of Serbia adopted on January 31st 2015 the *Fiscal Strategy for 2015 with projections for 2016 and 2017,* which outlines economic policy for the medium-term by focusing on ensuring sustainable economic growth and financial stability, curbing debt, and supporting better business environment. Growth is expected to gradually recover, inflation is expected to stay at the low level, and balance of payment is foreseen to further improve. To reduce the fiscal deficit and public debt, we will implement an ambitious plan for fiscal consolidation and structural reforms under the forthcoming IMF program. We reached a staff level agreement with the IMF on the 3-year program to support the necessary fiscal adjustment, while at the same working on the design and implementation of various structural reforms with the World Bank and other IFIs. We will implement those reforms in order to foster growth, improve competitiveness, and increase exports and investment in industry and agriculture. Furthermore, we expect that the improved global economic outlook and gradually that of the Eurozone will positively impact economic activity and employment in the Republic of Serbia.

Serbia's economy was hit hard by the international financial crisis which started in late 2008 as well natural disasters in more recent years. As a result, our economy contracted three times in the period 2009-2014. It is important to stress that recessions in 2012 and 2014 were primarily caused by natural disasters – a drought in 2012 and severe floods in 2014. In addition, weak recovery of our main trading partners and economies from the region as well as internal structural bottlenecks prevented the economy from recovering more rapidly.

Nevertheless, the growth model for Serbian economy has gradually changed – from the one driven by domestic demand toward exports led growth. Since 2010, and in particular in 2013 when the carmaker FIAT started production in Serbia, exports were a significant driver of growth. We are aware that in 2014 exports began slowing down but we believe that it is due to some one-off effects, including: lower energy sector production (due to floods); slower sales performance of FIAT; and a temporary decrease in exports of state-owned enterprises awaiting privatization.

We expect stronger economic recovery from 2016 onwards since for 2015 we project a small decline of economy. Projections for 2015 include assumptions related to a negative impact on growth from the necessary fiscal adjustment; as well as cautious projections related to exports growth. Starting in 2016, we expect moderate recovery of the private consumption as well as a stronger growth of investments and exports. Real GDP is estimated to grow at 1.5 percent in 2016, and 2 percent in 2017.

Over the medium-term and supported by the IMF program, we envisage a significant fiscal adjustment. The general government deficit is projected to fall from the 6.6 percent of GDP in 2014 (this is augmented fiscal deficit) to 3.8 percent of GDP until 2017. This is expected to stabilize Serbia's public debt to below 80 percent (78.7) of GDP by 2017, after which, it is expected to decline gradually. This macroeconomic outlook is supported by many of the reform measures introduced as part of the 2014 supplementary budget, and most importantly includes reduction of the public sector wage bill (by 10%) as well as progressive reduction of pensions (threshold for both, wages and pensions is 25.000 RSD).

During previous several months we have adopted several important legislative and regulatory changes which will underpin our structural reforms. These include:

- Labor Law adopted during the summer of 2014, which increases flexibility of the labor market in the Republic of Serbia, by making it easier and cheaper to hire and fire workers.
- During 2014, the Law on Pension and Disability Insurance has been amended, including the following: (1) increasing the legal age of retirement for women from 60 to 65 years until 2032 (6 months per year until 2020, 2 months per year thereafter); (2) increase the minimum retirement age from 58 to 60 years by 2023, and (3) the introduction of a penalty of 4% per annum for early retirement.
- Amendments to Law on Construction and Planning, adopted at the end of 2014, which will significantly streamline issuance of construction permits, a major bottleneck in Serbia's investment climate.
- Law on Privatization, adopted during the summer of 2014, to introduce more flexibility for the remaining privatizations.
- Amendments to Law on Bankruptcy, adopted during the summer of 2014, to set clearer rules and streamline procedures.

- Introduction of across the board e-payments of taxes, significantly easing the administrative burden on enterprises.

The Government is committed to implementing additional structural reforms which will elevate the country closer to a fully functional market economy in medium term. These reforms include:

- State administration reform for which Action Plan has recently been adopted. Support for this reform is being provided by the World Bank and the EU.
- Subsidy system reform for which new legislation will be adopted during first half of 2015.
- In the following period, the process of strengthening fiscal responsibility of local governments will continue, with the aim to increase the fiscal capacity of local governments, ensure better collection of revenues, higher service quality, greater efficiency of local utilities, restrict employment and efficient spending of funds and thus reduce the need for transfers from the budget of the Republic of Serbia.
- Reform of business inspections for which new Law on Inspections will be adopted during first half of 2015.
- Longer term education and healthcare system reforms.

We have reached the staff level agreement with IMF team and since the Government of Serbia got the full support of the direction in which reforms are going. The implementation of necessary fiscal measures and structural reforms will be underpinned by the IMF precautionary agreement which is expected to be approved by their board in February 2015.

Program of Reforms in the SOE Sector

The Government is committed to transforming the Republic of Serbia into a fully functioning market economy with a vibrant private sector. Many of Serbia's State-Owned Enterprises are not competitive, and add pressure to the fiscal position (of around 3 percent of GDP). The ongoing reforms, and support by this series of Policy Loans makes it possible to restructure non-competitive enterprises, and improve the governance of remaining SOE's, while compensating and supporting the workers who will be affected by this process.

Restructuring and Divestiture of Companies in the Privatization Agency Portfolio

As outlined in our *Fiscal Strategy for 2015 with projections for 2016 and 2017*, one of the main structural reforms that we will implement over the next year is to accelerate and finalize the privatization process. Some of the affected companies can become profitable again, and assets can be employed more productively to contribute to the economy. However, many of the companies in the portfolio of the Privatization Agency (PA), particular those that were in restructuring as of August 13th, 2014, are adding substantial pressure to the budget. These costs are direct, in the form of direct subsidies and soft loans. Indirect costs in the form of unpaid taxes and contributions and unpaid utility bills are much more significant and have multiple negative spill-over effects on the rest of the economy. Some of our large utilities are in precarious financial position and need substantial support from the Budget to offset the costs accrued by unpaid bills from companies that were in restructuring status. Finally, companies from the Privatization Agency portfolio control significant assets which need to be reallocated for a more productive use.

In August 2014 we have adopted a new Law on Privatization, which introduced more flexibility in models and methods of privatization, specified a clear timeline for resolving the remaining companies in the PA portfolio and helped us reinitiate the process of privatization for all of the companies in the PA portfolio. The new Law on Privatization includes provisions for addressing damage inflicted to environment prior to entity's privatization, indicating the responsibility of the State to provide the necessary budget funds for covering the cost of addressing the damage. Furthermore, the new Law on Privatization reaffirmed that the protection of debtors under restructuring regime will be removed by mid-2015.

We have made good progress on implementing initial steps as defined by the Law on Privatization. We collected Letters of Interest (LOIs) from potential investors for all companies, and on that basis prepared initial proposals for resolution of each individual company from the PA portfolio. On the basis of these proposals, the MOE (in case of companies with majority socially owned capital), the Government (in case of companies with majority state owned capital), or local governments (in case of companies with majority local government owned capital) adopted formal decision on the resolution model. We have decided that the companies from the PA portfolio will be resolved using the following models:

(i) A group of 188 companies with about 5,000 workers will be sent to bankruptcy by June 2015. In January 2015 we have adopted an Action Plan authorizing the PA to start initiating the bankruptcies in these companies as soon as workers have received social programs (financial compensation in lieu of severance packages). For 76 companies from this group the bankruptcy will be initiated immediately after the adoption of the Action Plan (i.e. in February), and for the remaining companies it will be initiated until June, once the social programs have been completed.

(ii) For 147 companies, with about 24 thousand workers equity sale will be attempted. First public bids for these companies will be announced in late February.

(iii) For 30 companies, with about 12 thousand workers asset sale model will be used. Programs for asset sales prepared by companies will be delivered to the PA starting in February.

(iv) For 3 companies with about 3 thousand workers a mix of models will be used.

(v) For 24 companies with about 29 thousand workers strategic partnership model will be used.

(vi) For 19 micro companies with about 200 workers separate decision by the PA will be taken on privatization model.

(vii) For 7 companies further valuation data is needed and this process has been initiated. Once this data is collected, a decision will be taken on model of privatization.

(viii) In addition, there are 96 companies with approximately 15 thousand workers, for which the privatization process has been suspended. This includes companies based in Kosovo and Metohija, and companies which were founded by former Yugoslav republics. It also includes several companies where court cases are ongoing, and once they are completed the privatization is expected to be restarted.

We will continue implementing the Law on Privatization throughout the year, and are committed to have most of the portfolio resolved by the end of 2015. We expect that majority of the companies that were previously in status of restructuring will be resolved by the end 2015, either by privatization or bankruptcy. This process will be further reinforced by the fact that moratorium on debt enforcement against these companies will expire by May 2015. Further, we plan to complete most of the privatizations using asset sale model and equity sale model by the end of 2015.

Privatizations using strategic partnership model will be more complex, but we expect to initiate the process in most of the companies using this model during 2015. In respect to environmental damage occurred prior to the entities disposition, we will elaborate on the provisions of the Law on Privatization concerning past environmental damage and eliminating environmental risks in the law in the field of environmental liabilities which is under preparation.

Strengthening Governance, Institutional Framework and Transparency Arrangements for Public Enterprises

For a group of 24 Public Enterprises (which include all of the large utilities) we are continually improving the legal and regulatory framework in line with international standards and practices. The strengthened governance and accountability framework will have a direct impact on performance of these enterprises, which will also result in lower demand for direct and indirect state support, and improve Serbia's investment climate.

Over previous two years we adopted the new Law on Public Enterprises and all of the necessary by-laws to improve corporate governance and enhance transparency and accountability. The new legal framework includes provisions addressing most of the major weaknesses of the previous Law. It provides a good basis to modernizing the PE governance framework by addressing key legal gaps and enabling the implementation of principles of depoliticization and professionalization. The new PE Law provides companies a choice of two models of corporate governance for PEs - one-tier and two-tier system – similar to the one provided for under the Company Law. The two tier model gives stronger powers to the Supervisory Board, which becomes a strategic corporate body overseeing the management with clearly define mandate and functions, including internal audit and controlling ones. The new law also introduces educational and professional criteria for the selection of the Supervisory Board members, as well as clearer criteria related to the dismissal of Board members. It also introduces an independent member of the Supervisory Boards, albeit the criteria of independence need to be further strengthened. A significant new provision in the law is the requirement to nominate all general managers of PEs in public competition procedure, followed by a formal and regulated selection procedure. The new law specifically provides for an obligation to perform audit of financial statements of each PE, and a further obligation of all national level PEs to institute an audit committee.

Finally, new PE Law brought significant improvements related to transparency and disclosure. This includes introducing detailed quarterly reporting to Ministry of Economy; the reports include detailed data on financial performance of companies, including quarterly income statements, balance sheets and cash flow statements; the reports also include detailed data on liabilities, arrears to other state entities and to private companies, as well as data on employment and wages, and on prices charged for services. The new PE Law further calls for making annual business plans public, and introduces the obligation to present a special program related to the usage of any state aid.

We will continue to strengthen the corporate governance framework for our Public Enterprises. This will include further defining the criteria, in line with the PE law, for dismissal and performance bonuses of Board members and managers. We will work on defining criteria to assess the performance of the management, aiming to clearly link the performance assessment to the achievement of key performance indicators that would be agreed to between the government and the PE in advance and publicly disclosed. Further, to accompany the process of corporatization envisaged in some large PEs, the legal framework should be further enhanced to ensure continued adequate oversight of the corporatized state owned enterprises. The checks and balances provided for under the common corporate governance rules in the Companies Law do not provide sufficient comfort for the adequate supervision and functioning of the SOEs where the state is either a single shareholder or a dominant shareholder. State has shareholdings in numerous, important and complex companies, and given the status of administrative resources in Serbia, it is not realistic to expect the Government to perform the usual role of a diligent owner and shareholder in all such companies. Therefore, additional rules outside of the scope of the corporate governance rules laid by the Company Law, should be instituted to regulate SOEs so as to enable: (1) better control and supervision of SOEs by the Government (such as the obligation to submit to the government for approval the annual business plan), (2) increased transparency of SOEs activities and governance to the public (such as imposing on them the same transparency requirements as are currently required for all publicly listed companies), and (3) enhancement of the selection process of board members and key managers (such as a public procedure for the appointment of general managers). However, such rules should be designed so as not to significantly decrease SOEs competitiveness on the market.

We have made good progress in implementing the new regulatory framework for Public Enterprises. Almost all of the PEs have adopted new Founding and Statutory Acts in line with the new Law. Supervisory Boards according to the new corporate governance arrangements have already been established in 22 out of 24 republican level PEs. The directors have been appointed using new competitive procedure in several PEs, and procedure has been initiated in several other PEs. Finally, Audit Committees have been established in about half of PEs, and we will continue the process in the remaining PEs during 2015.

We are implementing a new legal framework for accounting and auditing, with the goal to further enhance reliability of financial information both for SOEs and also for all other companies, as well as to lay the foundations for improved corporate governance, accountability, and performance assessment. The new Law on Accounting and Law on Auditing enacted in July 2013 are an important step towards the effective introduction of international standards and the transposition of the *Acquis Communautaires* in financial reporting and audit. The new laws established financial reporting and auditing requirements for micro, small and medium, and large and public-interest entities. International Financial Reporting Standards (IFRS) were designed for listed companies and other "public interest entities". The Auditing law introduced quality assurance and a system of public oversight over Statutory Auditors. Improved quality of financial information, the introduction of public oversight for the audit function, and the strengthening of quality assurance systems for audit, are all critical to corporate governance, accountability, performance assessment, and should help attract investment, including in State-owned enterprises.

Mitigating the Social and Labor Market Impact

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. 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.

We have created a special budget-financed fund, the Transition Fund, which provides several options for financial assistance from which redundant workers can chose from in lieu of severance pay.[1] The 2015 Budget has allocated RSD16 billion (approximately EUR130 million) for this purpose, which based on previous severance programs could cover more than 20,000 redundant workers. In January, we have adopted a new Decree detailing the options available to workers, and aiming to offer adequate and equitable financial compensation, while addressing the issues on equity of the packages from previous years. Under the new Decree, the main package offers financial compensation as foreseen in the labor code, only taking into account work history with the last employer. This is an adequate package and also ensures equity between redundant workers in the public and private sector. Nevertheless, in order to avoid packages that could jeopardize financial sustainability of the proposed program, and to avoid abuse by workers that have high wages on record, but are actually paid less in reality, this package will be subject to caps. In particular, packages cannot exceed a total value of EUR 8,000 per redundant worker; and not more than 500 EUR can be accrued per year of service with the last employer. In addition, in line with past practice, a package of EUR 200 per year of service is being offered for the entire work history.[2] This package is targeted at low-wage earners who would receive relatively little under labor code provisions. A third option offers six monthly average wages to workers with a minimum of 15 years of work history. In addition, a certain group of workers, employed by the companies that will go into bankruptcy[3],with long contribution histories would qualify for an old-age pension—albeit very small one—and therefore would not be eligible to any of the above financial compensation packages. For these workers, a small compensation of two monthly average wages is offered.

Because the packages offered under the adopted 2015 decree are by and large in line with labor code provisions, a number of redundant workers are expected to also qualify for unemployment benefits, which will ensure sustained financial assistance to redundant workers over a longer time period and link redundant workers with services offered by the National Employment Service (NES).[4] The local branch offices of NES are closely involved in the implementation of social programs for redundant workers of public enterprises providing advice at several stages. In addition, the National Employment Action Plan, which outlines the annual provision of active labor market programs by the NES, has specific provisions for making ALMPs available to redundant workers form public enterprises. Further, we will improve the outreach of NES to redundant workers to insure they are fully aware of the available options. In line with best practice from other countries, the NES will be required to visit every company that announces redundancies of more than 10 workers and inform redundant workers about the services and programs available at NES, including about the eligibility criteria for unemployment benefits. In order to improve jobs prospects of redundant workers, NES will also be required to strengthen their efforts to register job vacancies in the surrounding area of the public enterprise where redundancies will occur. The annual performance agreement 2015 between MoLEVSA and NES will include requirements for NES to perform these activities and ensure that the necessary data to monitor their implementation is collected. Support to NES in the efforts to strengthen its capacity and improve services for the unemployed are being supported by the World Bank and other partners, like the EU. The Word Bank supports MoLEVSA though a Technical

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[1] The offered packages are not considered severance pay since workers voluntarily chose to leave the company if they sign up for the program.
[2] An additional provision ensures that no compensation is being paid for those years for which the worker has previously received severance pay.
[3] 188 companies employing around 5,000 workers
[4] In the past, many redundant workers received packages in access to labor code provisions, which disqualified them from receiving unemployment benefits.

Assistance program, co-financed by the European Commission, to draft a new National Employment Strategy Further, the Government has already identified weaknesses in the NES and the design of ALMPs and social benefits and committed to key reforms in these areas. This combination of technical assistance and operational support should considerably enhance the capacity of NES to support redundant workers and improve the quality of their services and programs over the next four years.

The Government is committed to improving the design of its public works program so that it can better serve as an additional safety net for vulnerable groups, including redundant workers. The NES offers a range of labor market programs, including wage subsidies, start-up support, public works, re-training, job counseling, and job search assistance. Of these, public works is of particular importance because it gives the long-term unemployed, who have little to no chances of finding proper employment, the possibility to earn some income, at least for some months during the year. A well-designed public works program could fulfill the role of an additional safety net. Yet, the public works program in its current design raises concerns if it can fulfill this role. Well-designed public works program are self-targeted by paying considerably less than minimum wage; and the jobs done under public works are not replacing proper jobs. The Government is considering re-designing the current public works program to pay a stipend instead of a wage; and to limit public works to less-than-full-time tasks that support communal activities like, for example, elderly care; to restrict eligibility for public works to long-term unemployed (more than one year, possibly two years of uninterrupted unemployment); and to limit the duration of public works to six months of the year and person.

The Government is committed to reducing disincentives for formal sector work—in particular mini-jobs and self-employment in micro-enterprises. Past experience from privatization has shown that many redundant workers, especially older ones, have obsolete skills and end up in informal "mini-jobs"—that is, casual, low-paying part time work or self-employment in micro enterprises. To encourage formal job creation in this segment of the labor market—especially formal jobs that guarantee a minimum level of protection of workers—some of the significant disincentives have to be addressed. A significant disincentive is the minimum social security contribution. The minimum contribution is calculated from a base set at 35 percent of average wage and is not pro-rated by actual hours worked. Any job earning less than 35 percent of average wage—including part-time jobs—has to pay the contributions as if earning 35 percent of average full-time wage. That is, part-time jobs around the hourly minimum wage are hugely penalized through this floor, making them entirely unviable in the formal sector. This minimum contribution might be a significant barrier for the employment of women, as in many Western European countries women – often with care duties – form a significant share of part-time workers. To provide better employment opportunities for redundant workers in particular, but also for other vulnerable workers and women, we will assess the impact of the existing social security regime on the labor market and propose measures to remove disincentives for formal employment opportunities for low–paying part time work and self-employment, taking into account the medium term macro fiscal framework.

Sincerely Yours,

MINISTER

Ph.D. Dušan Vujović

ANNEX 3: FUND RELATIONS ANNEX

IMF Executive Board Approves EUR1.2 billion Stand-By Arrangement for Serbia
Press Release No. 15/67, February 23, 2015

The Executive Board of the International Monetary Fund (IMF) today approved a three-year, SDR 935.4 million (about EUR1.2 billion, 200 percent of quota) new Stand-By Arrangement for Serbia. The Serbian authorities have indicated their intention to treat the program as precautionary.

The program is based on three main pillars: restoring public finances' health; 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.

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

"The Serbian economy faces serious fiscal imbalances and entrenched structural weaknesses, in the context of slower growth and adverse regional spillovers. The authorities' Fund-supported program offers an opportunity to restore public debt sustainability, rebalance macroeconomic policies, enhance financial sector resilience, and improve competitiveness and medium-term growth potential. The authorities should be commended for strengthening the credibility of reform plans by taking difficult but necessary measures in 2014, including labor and pension reforms.

"Serbia's high and rising public debt calls for fiscal consolidation in the period ahead. The authorities' fiscal package, which aims to place the debt-to-GDP ratio on a downward path by 2017, is appropriate. The focus on containing mandatory expenditure, reducing state aid, and minimizing fiscal risks arising from state-owned enterprises is warranted. The fiscal program will also be supported by improving the public financial management framework.

"Fiscal consolidation creates room for gradual monetary easing, which will support domestic demand as the fiscal stimulus is withdrawn. The pace of monetary policy adjustment should take into account external financing conditions and the evolution of inflation expectations. Exchange rate flexibility remains an important shock absorber for Serbia and foreign exchange interventions should remain limited to smoothing excessive volatility.

"Preserving the stability of the financial sector and strengthening its resilience will safeguard the economic recovery. Special diagnostic studies should verify the health of banks and guide financial sector policies, going forward. A comprehensive strategy to address high non-performing loans would help clean up balance sheets and improve financial intermediation. Recent reforms to the bank resolution framework will improve the efficiency of the system and mitigate fiscal risks.

"The authorities' commitment to broad-based structural reforms is welcome. Wide-ranging reform of state-owned enterprises, especially large ones, will be critical for reducing state aid and limiting the drag on the budget. The business climate needs to be improved to attract new investment, foster job creation, and support growth over the medium term."

The Executive Board also concluded the 2014 Article IV consultation with Serbia.

Recent Economic Developments

Serbia's GDP contracted in 2014 due to continued falling domestic demand aggravated by floods, and weak economic activity among trading partners. A high rate of unemployment remains one of the largest social concerns, as chronic structural rigidities continue to undermine the overall competitiveness of the economy. The recession in 2014 was the third in the last six years.

Public debt has risen rapidly to uncomfortably high levels, and despite some fiscal consolidation efforts in recent years, the fiscal deficit rose to 6.6 percent in 2014, due to higher state aid to loss-making SOEs and mandatory spending. Public debt reached over 70 percent of GDP in 2014.

Program Summary

The program's three main pillars are:

• **Strong fiscal consolidation over the program period and rebalancing of policy mix.** The fiscal adjustment, already initiated in late 2014, is largely based on curbing mandatory spending and reducing state aid to state-owned enterprises (SOEs). The tighter fiscal stance will create space for easing of monetary policy, which will foster credit growth to the economy. Some of the major measures, related to pensions and public sector wages, have already been introduced in 2014 or are included in the 2015 budget, highlighting high ownership of the program.

• **Strengthening of the financial sector.** The program aims to support financial sector stability and resilience and improve financial intermediation. While the banking sector (composed mostly of foreign-owned banks) has remained adequately capitalized and highly liquid, nonperforming loans (NPLs) are a significant challenge. Addressing high NPLs will be essential to improve the creditworthiness of potential borrowers and recovery of credit to the economy, which has been contracting until recently. The Serbian authorities are committed to designing and implementing a comprehensive strategy for reducing NPLs. Increasing the dinarization of the economy is also one of the key objectives.

• **Boosting competitiveness and growth.** Structural reforms are essential to enhance Serbia's growth potential. There are three broad priorities to be implemented over the medium term: job creation; improvement of the business environment and competitiveness; and resolution and reform of SOEs, aiming at a significant reduction in the number of these enterprises (a first group of about 500 companies are slated for resolution or privatization). In terms of job creation, the Serbian authorities already took important steps in mid-2014, amending the Labor Law to remove disincentives to hiring, and making wage bargaining and employment procedures more flexible. One important measure in fostering investment is a revamp in the regulatory framework for issuing construction permits, aimed at streamlining the process.

Serbia has been a member of the IMF since December of 1992 and has a quota of SDR 467.7 million.