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R2016-0195/1

October 3, 2016

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<p><b>Closing Date: Tuesday, October 25, 2016 at 6 p.m.</b></p>
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FROM: Vice President and Corporate Secretary

**Serbia - Second Programmatic State Owned Enterprises Reform Operation**

**Program Document**

Attached is the Program Document regarding a proposed development policy loan to Serbia for a Second Programmatic State Owned Enterprises Reform Operation (R2016-0195), which is being processed on an absence-of-objection basis.

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Report No. 108294-YF

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED

DEVELOPMENT POLICY LOAN  
IN THE AMOUNT OF EUR 89.8 MILLION  
(US\$100 MILLION EQUIVALENT)

TO

THE REPUBLIC OF SERBIA

FOR THE

SECOND PROGRAMMATIC STATE OWNED ENTERPRISES REFORM OPERATION

September 27, 2016

Trade and Competitiveness Global Practice (GTCDR)  
Europe and Central Asia (ECA)

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## **REPUBLIC OF SERBIA FISCAL YEAR**

January 1 – December 31

### **CURRENCY EQUIVALENTS**

(Official Exchange Rate Effective as of September 1, 2016)

Currency Unit	Serbian Dinar
RSD 1.00	US\$0.009
US\$1.00	RSD 110.21

Metric System

### **ABBREVIATION AND ACRONYMS**

ALMP	Active Labor Market Programs
ALSU	Bankruptcy Supervision Agency
BOP	Balance of Payments
CAD	Current Account Deficit
CPF	Country Partnership Framework
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
MTEF	Medium Term Expenditure Framework
NBS	National Bank of Serbia
NEAP	National Employment Action Plan
NES	National Employment Service
NIS	Naftna Industrija Srbije (Oil Company)
NPLs	Non-performing 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
PPS	Public Policy Secretariat
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
SBA	Stand-by Arrangement
SCD	Systematic Country Diagnostic
SFA	Social Financial Assistance
SOEs	State-Owned Enterprises
TA	Technical Assistance
US\$	United States Dollar

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**REPUBLIC OF SERBIA**  
**SECOND PROGRAMMATIC STATE OWNED ENTERPRISES REFORM**  
**DEVELOPMENT POLICY LOAN**

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**LOAN AND PROGRAM SUMMARY**  
**SECOND PROGRAMMATIC STATE OWNED ENTERPRISES 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 (MoLEVSA), the Privatization Agency (PA), and the Bankruptcy Supervision Agency (BSA).
Financing Data	IBRD Loan  Terms: Variable Spread Loan with fourteen and a half (14.5) year grace period and bullet repayment. Amount EUR 89,800,000 (US\$100 million equivalent).
Operation Type	The proposed Second Programmatic State Owned Enterprises (SOEs) Reform Development Policy Loan is the second in a series of two Development Policy Loans (DPLs) designed to support the Republic of Serbia reform program of the state owned enterprise sector.
Pillars of the Operation And Program Development Objectives	<p>The Program Development Objectives (PDOs) are to reduce state participation and level of direct and indirect support to the real sector, enhance SOEs 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:</p> <p><u>Pillar A:</u> Accelerating the restructuring and divestiture program for the PA portfolio and selected SOEs operating in the commercial sector.</p> <p><u>Pillar B:</u> Strengthening governance, regulatory and institutional framework, and monitoring and transparency arrangements for state owned enterprises.</p> <p><u>Pillar C:</u> Mitigating the social and labor market impact of the state owned enterprises reform program.</p>
Results Indicators	<p><b>Result Indicator A1</b>—Reduction of direct and indirect support to companies in the PA portfolio:</p> <ul style="list-style-type: none"> <li>- Annual direct subsidies and soft loans (million Euro): <ul style="list-style-type: none"> <li>o Baseline (average 2010-2012): 85; Target (2017): less than 5</li> </ul> </li> <li>- New tax obligations and social contributions arrears: <ul style="list-style-type: none"> <li>o Baseline (average 2010-2012): 190; Target (2017): less than 5</li> </ul> </li> <li>- New arrears to public utilities: <ul style="list-style-type: none"> <li>o Baseline (average 2010-2012): 70; Target (2017): less than 5</li> </ul> </li> </ul> <p><b>Result Indicator A2</b>—Disposal and treatment of legacy hazardous waste generated by companies in the Privatization Agency portfolio:</p> <ul style="list-style-type: none"> <li>- Total volume of legacy hazardous that was disposed and/or treated (tons of waste)</li> </ul>

	<ul style="list-style-type: none"> <li>○ Baseline (2014): 0; Target (cumulative, 2015 - 2017): 1,500</li> </ul> <p><b>Result Indicator B1</b>—Audited financial statements prepared and published by enterprises in accordance with provisions of Law on Public Enterprises (PE) and new Laws on Accounting and Auditing for Public Enterprises for which the founder is the Republic of Serbia: Baseline (2012, none); Target (2017, all required).</p> <p><b>Result Indicator B2</b>—Reduction of direct subsidies and issuance of new guarantees for liquidity purposes for remaining large SOEs:</p> <ul style="list-style-type: none"> <li>- Direct subsidies for recurrent expenditures (million Euro) <ul style="list-style-type: none"> <li>○ Baseline (average 2010-12): 250; Target (2017): less than 150</li> </ul> </li> <li>- Annual guaranties for liquidity purposes (million Euro): <ul style="list-style-type: none"> <li>○ Baseline (average 2012-2014): 265; Target (2017): 0</li> </ul> </li> </ul> <p><b>Result Indicator C1</b>— Number of redundant workers receiving compensation from the Transition Fund increases from approx. 5,700 (2014) to at least 25,000 (cumulative 2015 and 2016) (to be monitored by gender).</p> <p><b>Result Indicator C2</b>— At least 30 percent of workers made redundant from public enterprises during 2016 register with NES (to be monitored by gender).</p> <p><b>Result Indicator C3</b>—Number of participants in public works increases from 2,882 in 2013 (1,187 female and 1,695 male) to at least 7,000 in 2016 (to be monitored by gender).</p>
Overall risk rating	Substantial
Operation ID	P149750





**PROGRAM DOCUMENT FOR A  
PROPOSED SECOND 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 Second State Owned Enterprises Reform Development Policy Loan (DPL) to the Republic of Serbia for an amount of EUR 89.8 million (US\$100 million equivalent).** This is the second loan in a programmatic series of two operations supporting Government of Serbia's structural reform program for the state owned enterprises (SOEs) sector, which aims at reducing state participation and level of direct and indirect support to the real sector, enhancing SOEs performance, governance and accountability, and mitigating the short term social and labor impacts of the SOEs restructuring and disposition plans. The measures supported under the proposed series are an integral part of the Government of Serbia's (GoS) Fiscal Strategy for 2016–18, as well as the Program of the new Government of Republic of Serbia, presented by the Prime Minister to the Parliament in August 2016. The proposed series is fully congruent with the FY16-20 Country Partnership Framework and contributes to both of its focus areas (Area 1: the "Economic governance and the role of the state" and Area 2: "Private sector growth and economic inclusion") 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 global financial 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 2001–08 was driven mainly by domestic consumption and was unsustainable, resulting in significant internal and external imbalances. The crisis further exposed 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 77 percent of GDP in 2015. Similarly, the stock of public guarantees, issued mainly to SOEs, increased from around 3 percent of GDP in 2008 to a peak of 8.4 percent at end-2013, and has gradually declined since (standing at 7.3 percent at end-2015).

3. **The crisis also resulted in a deterioration of the living conditions in Serbia, though poverty has slowly receded since peaking in 2010.** Poverty estimates using the \$5/day poverty line (2005 PPP) registered a peak in 2010, when it reached 15.1 percent, up from 10.6 in 2008. Most of the poverty increases in this period were concentrated in rural areas. Since then, poverty has decreased slowly to 14.5 percent in 2013, the latest year for which comparable data is available. In 2012, Serbia adopted the EU relative poverty measure—the fraction of the population living below 60 percent of the median income—as its official poverty rate. Using this indicator based on the 2015 EU-SILC survey for Serbia, relative poverty in Serbia was estimated at 25.4 percent, higher than all new EU member states with available relative poverty rates. Although pre-crisis growth had particularly benefitted the poor and bottom 40 percent of the population, the crisis hit them disproportionately. Consumption among the bottom 40 percent declined more than the average due to losses in employment and labor income. Labor market outcomes has improved slightly in recent years, though unemployment remains high—at 15.2 percent in the second quarter of 2016—and the employment rate stands at only 45.9 percent (for population older

than 15). Inequality in the country, measured using disposable income, was estimated at 38.2 Gini points in 2015, higher than all new EU member states with comparable data.

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.** Following the elections of March 2014 and early elections of April 2016, a government with a strong majority was formed, giving Serbia a new opportunity to overcome the fragmentation that characterized the past and build momentum for reform. The government is committed to focus on transforming the state administration, public finances and the economy, along with pursuing the EU accession process. The economic program for 2015-2018 focuses 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, creating the foundations for faster growth and private-sector led job creation over the medium term.

5. **The reform of SOEs 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 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, and accumulation of 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 the level of direct and indirect support to the real sector, enhance SOEs' performance, governance and accountability, and mitigate the short-term social and labor impacts of the SOEs 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) accelerating the restructuring and divestiture program for the Privatization Agency portfolio<sup>1</sup> and selected state owned enterprises operating in the commercial sector; (ii) strengthening governance, regulatory and institutional framework, and monitoring and transparency arrangements for SOEs; and (iii) mitigating the social and labor market impact of the SOEs reform program.

7. **The overall risk of the proposed series is substantial.** 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 that could slow down or derail their implementation. The overall risk of backtracking is mitigated by the successful implementation track record of the first operation in the series. The overall and political risks are further 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

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<sup>1</sup> Privatization Agency portfolio refers to all companies for which the privatization process has been initiated. The Privatization Agency itself has been shut down in January 2016, and the responsibilities for managing the portfolio and resolution of these companies transferred to the Ministry of Economy and the Bankruptcy Supervision Agency.

reforms. The overall risk is further mitigated by the ongoing IMF Stand-By Arrangement (SBA) and the parallel Public Expenditure and Public Utilities DPL series currently under preparation, both of which build on several of the reforms supported by the series, most notably the divestiture of the PA portfolio and improved performance of public utilities. The series includes a pillar specifically dedicated to mitigating the social and employment impact of the program. Finally, the Bank is also supporting 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 recent economic performance has been positive, as growth recovers from the three recessions experienced from 2009 to 2014.** After growing by 5.9 percent a year on average during the decade before the 2008 global financial crisis, the economy contracted by 3.1 percent in 2009 and, after a timid recovery in 2010 and 2011, fell back into recession in 2012 and 2014. While the 2009 recession was mainly due to the severe impact of the international economic crisis, the 2012 and 2014 recessions were primarily caused by natural disasters – a drought and severe floods respectively. In response to the growth slowdown, and a sharp build up in government debt, government reforms have focused on fiscal consolidation and structural reforms to put growth back onto a sustainable path and address external and fiscal imbalances.

9. **Supported by the recovery of industrial production following the 2014 floods, positive growth returned in 2015 and picked up further in 2016.** Growth of 0.7 percent for 2015 as a whole was above initial expectations of a contraction. Industry was the primary driver, with real value added up 5.8 percent y/y (in part reflecting base effects as the impacts of the May 2014 floods unwound). In contrast, real agriculture value added was hit by the summer drought, contracting by 7.5 percent y/y. Services sector value added posted a small decline. The recovery continued into 2016, with strong y/y growth of 3.5 percent in Q1 and 1.8 percent in Q2, according to flash estimates.

10. **Investment and net exports have supported the recovery in growth.** Unlike in 2014, when all components of GDP had a negative contribution to growth, investment and exports increased significantly in 2015 (up 5.5 and 7.9 percent y/y respectively), aided by the recovery from the floods, and improved external demand. However, consumption has been under pressure from cuts in public sector wages and pensions and indeed fell by 0.7 percent y/y in 2015. In early 2016, all components of GDP posted a strong growth. Most importantly, net exports contributed 2.5 and 1.4 percentage points respectively to growth in Q1. Both private and public consumption also started to increase. The moderation in growth Q2 was in part due to a slowing in investment (both private and public).

11. **Improved export performance has supported the external adjustment following the crisis, with the current account deficit falling from 11.5 percent of GDP in 2012 to 4.8 percent in 2015.** Since 2010, and in particular in 2013 when the carmaker FIAT started production in Serbia, exports have been a significant driver of growth and narrowing in the trade deficit. Following the 2014 floods, exports recovered to grow by 7.8 percent in 2015 (in euro terms). The broad-based growth of exports over the first five months of 2016 reached 10.5 percent (y/y). The fall in the merchandise trade deficit has supported the narrowing in the current account deficit, particularly in 2013, although an improved service balance and net transfers were the main drivers of the narrowing in 2015 to 4.8 percent from 6 percent of GDP. The current account deficit continued to decline in the first four months of 2016, down 47 percent

y/y, mainly as a result of a significantly lower trade deficit. In the financial account FDI has been on a positive upward trend, moving from 2.1 percent of GDP in 2012 to 5.5 percent in 2015, more than covering the current account. These positive trends continued in 2016.

12. **The recent recovery in economic activity has been reflected in improved labor market outcomes.** High unemployment, in particular among youth, is a longstanding issue in Serbia. The unemployment rate reached a peak of 24 percent in 2012 but has been on a declining trend since. Results from 2015, as growth recovered, were particularly encouraging with the annual unemployment rate falling to 17.7 percent. There was some reversal in Q1 2016, mainly due to seasonal factors, with unemployment rising to 19 percent (matching Q1 2015). Unemployment rate improved in Q2 going down to 15.2 percent. Overall real wages fell again in 2015, down 2 percent y/y, following declines of 1.5 and 0.8 percent over 2013 and 2014 respectively. However, wages increased over the first half of 2016 by 4.2 percent y/y in nominal or 3.2 percent in real terms.

13. **Despite monetary policy easing, inflation continues to undershoot the inflation target band of the National Bank of Serbia (NBS).** Low energy and food prices, and still relatively weak domestic demand, contributed to average consumer price inflation of 1.9 percent in 2015, below the NBS target band of  $4 \pm 1.5$  percent. Over the first five months of 2016, inflation averaged 1.1 percent y/y. Faced with low inflation, NBS continuously has lowered its key policy rate since May 2013. In 2015, NBS cut the key policy rate seven times, reducing it from 8 to 4.5 percent between January and October, and keeping it unchanged until February 2016. The latest cut in the key policy rate was in early July 2016 (to 4 percent). The NBS's inflation targeting framework and commitment to maintain a flexible exchange rate are deemed appropriate, although high levels of euroization limit the monetary transmission mechanism.

14. **While falling against a strengthening US dollar, the Serbian dinar has been relatively stable against the Euro.** The current account improvement in 2015 supported the dinar against the Euro. While flat against euro, the dinar depreciated significantly against US dollar in 2015 (with the annual average exchange rate down 11.8 percent y/y), particularly earlier in the year, in line with other emerging economy currencies. In early 2016 the dinar depreciated slightly against the euro, but it has remained stable since. NBS continues to intervene regularly to prevent more significant fluctuations in the exchange rate against the euro. The average real effective exchange rate depreciated by 5 percent in 2015 relative to 2014 and as of July 2016 was down a further 1 percent on its 2015 average level.

15. **The financial system is broadly stable, although weaknesses remain in some state-owned banks.** The Serbian financial system weathered the global financial crisis and successive recessions relatively well, but a weak domestic economy resulted in a substantial increase in nonperforming loans (NPLs) (which stood at 20.4 percent as of April 2016) and reduction in profitability. While banks remains well-capitalized and liquid, additional challenges emerged related to the situation in Greece, since there are four Greek banks operating in Serbia (accounting for about 11 percent of total assets in Q1 2016). The NBS has undertaken steps to prevent any shocks in these, and other commercial banks, through intensified oversight. In addition, the NBS is actively working on the resolution of the longstanding problem of non-performing loans under the new Action Plan for NPLs resolution (approved in August 2015). NPLs went down by 1.2 percentage points over the first four months of 2016.

16. **Credit continued to recover in 2016.** Total loans were up 14.6 percent in May 2016 (y/y) mainly because of a significant increase of banks' lending to the government sector. Household loans were up 6.2 percent while those to enterprises (both private and SOEs) were 2.8 percent higher y/y, in line with the recovery in investment, as well as lower interest rates. This includes a return to positive growth for loans to private enterprises (up 6.8 percent y/y in May).

**Table 1. Key Macroeconomic Indicators and Projections**

	2012	2013	2014	2015e	2016p	2017p	2018p	2019p
<b>Real Economy</b>	Annual percentage change, unless otherwise indicated							
GDP (nominal, RSD)	5.2	8.2	0.8	1.7	4.4	5.4	7.2	7.6
Real GDP	-1.0	2.6	-1.8	0.7	2.5	2.8	3.5	3.5
Contributions:								
Consumption	-1.2	-0.6	-1.1	-0.7	0.6	0.8	2.3	2.3
Investment	0.6	-1.5	-0.1	1.1	1.3	1.6	1.2	1.1
Net Exports	-0.4	4.8	-0.6	0.3	0.6	0.5	0.1	0.1
Imports	0.7	2.6	3.0	3.2	4.1	4.0	4.0	4.3
Exports	0.3	7.4	2.3	3.5	4.7	4.5	3.9	4.4
Unemployment rate (average, ILO definition)	24.0	22.1	19.2	17.7	17.7	16.9	16.0	15.5
GDP deflator	6.3	5.4	2.7	0.9	1.8	2.5	3.5	4.0
CPI (eop)	12.2	2.2	1.7	2.1	2.0	3.5	3.5	4.0
<b>Fiscal Accounts</b>	Percent of GDP							
Expenditures	46.6	43.5	46.3	44.8	43.7	42.6	41.8	41.4
Revenues	39.4	37.9	39.7	41.1	41.3	40.4	40.1	39.8
General Government Balance	-7.2	-5.6	-6.6	-3.7	-2.5	-2.2	-1.7	-1.6
Public and Publicly Guaranteed Debt (eop) <sup>a</sup>	57.4	60.9	71.8	77.2	76.8	75.1	72.5	69.9
<b>Selected Monetary Accounts</b>	Annual percentage change, unless otherwise indicated							
Base Money	5.2	25.9	10.9	17.1	13.9	12.5	11.6	11.0
Credit to non-government	9.8	-4.5	6.1	2.0	4.5	6.0	5.6	5.0
Interest (key policy interest rate)	11.3	9.5	8.0	4.5	4.0	..	..	..
<b>Balance of Payments</b>	Percent of GDP, unless otherwise indicated							
Current Account Balance	-11.5	-6.1	-6.0	-4.8	-4.2	-3.9	-3.8	-3.9
Imports	44.3	42.8	44.6	46.7	47.1	49.2	49.7	50.3
Exports	26.5	30.7	32.2	34.5	36.2	38.3	39.0	40.0
Foreign Direct Investment	2.1	3.6	3.7	5.5	4.7	4.2	4.2	4.2
Exchange Rate (EUR, average)	113	113	117	121	..	..	..	..
<b>Other memo items</b>								
GDP nominal in EUR billion	31.6	34.3	33.3	32.9	33.7	35.0	37.5	39.7

Notes: a) World Bank projections. Includes non-guaranteed debt of local governments.

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

17. **The Government's fiscal consolidation program, put in place in 2014, has contributed to a significant improvement in fiscal performance.** The general government deficit in 2015 was 3.7 percent of GDP, down from 6.6 percent in 2014. The deficit reduction came primarily as a result of increased revenues (up 4.6 percent y/y in nominal terms). However, this was mainly supported by a major increase in non-tax revenues primarily due to one-off measures (i.e., payment of net income from state owned enterprises and proceeds from the sale of 4G licenses). Nominal government expenditures declined by 1.9 percent as a result of major savings from wage and pension reforms (down by 8.4 and 3.5 percent, respectively). Solid budget performance has continued in 2016. Revenues were up 8.7 percent y/y in H1 2016, although in this case the main driver was better collection of VAT. Expenditures rose by 6.3 percent, driven by purchases of goods and services and capital expenditures (up 14 and 42 percent, respectively). The general government deficit in H1 2016 was half its nominal value in H1 2015 and is projected to be 2.5 percent of GDP for 2016 as a whole (down from previously-projected 4 percent).

18. **General government debt (including guarantees) reached 77.2 percent of GDP at end-2015 and started to fall only in 2016.** Although the deficit narrowed, government debt as a share of GDP increased in 2015 by 6 percentage points compared to end-2014 data, partially explained by the US dollar strengthening in early 2015 (with 33 percent of debt dollar-denominated). Government debt decreased by 500 million euros over the first five months of 2016 to reach 75 percent of GDP.

## B. MACROECONOMIC OUTLOOK, DEBT SUSTAINABILITY AND RISKS

19. **Growth is projected to rise from 0.7 percent in 2015 to 3.5 percent by 2019, underpinned by more supportive external demand, improved investment, and gradual recovery of consumption.** Fiscal consolidation measures will limit the contribution of domestic demand to growth through 2017 but structural reform progress should support growth in investment and employment. After contracting in 2013 and 2014, private investment has been supporting recent growth and is projected to contribute around 1 percentage points to growth over the medium-term. This reflects primarily the impact of improvements in the investment climate (including, for example, reforms to construction permits, etc.). As activity and employment picks up, consumption is expected to be again the main driver of growth after 2017.

20. **The gradual narrowing of the current account deficit is set to continue, declining to 3.9 percent of GDP by 2019.** Improvements in the goods trade deficit will continue, in part due to external developments (low energy prices and recovery in the EU) and as a result of recent foreign investments, while the services surplus will also rise gradually. FDI inflows, supported by reform progress, are projected to be a solid 4 to 5 percent of GDP. These inflows are expected to provide the bulk of the net financing of the current account deficit, reducing external sustainability risks. Nevertheless gross external financing requirements remain sizeable at around 16 percent of GDP over the projection period (Table 2), with debt disbursements accounting for approximately three-quarters of overall external financing sources, highlighting potential vulnerability to shifts in international financial conditions.

**Table 2: Balance of payments financing requirements and sources**

(In percent of GDP)	2015	2016	2017	2018	2019
<b>Gross external financing requirements</b>	<b>13.3</b>	<b>13.1</b>	<b>15.9</b>	<b>15.8</b>	<b>17.3</b>
Current account deficit	4.8	4.2	3.9	3.8	3.9
Debt amortization	7.1	9.8	11.4	12.5	12.1
Change in gross reserves (increase=+)	1.4	-0.9	0.6	-0.5	1.3
<b>Gross external financing sources</b>	<b>13.3</b>	<b>13.1</b>	<b>15.9</b>	<b>15.8</b>	<b>17.3</b>
FDI and portfolio investments (net)	4.6	5.9	6.6	6.7	6.8
Official capital grants	0.0	0.0	0.0	0.0	
Debt disbursements	8.3	9.6	11.6	9.9	10.8
Other net capital inflows	0.4	-2.4	-2.3	-0.8	-0.3

Source: IMF; NBS

21. **Inflation is set to remain subdued in 2016 and to then pick up gradually as domestic demand recovers.** Increased prices in the second half of 2016 are expected to come primarily as a result of adjustment of administratively controlled prices. As domestic demand picks up, inflation is projected to rise, returning to the NBS target band in 2017. 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 2016 and beyond is set at 4±1.5 percent.

**Table 3: Consolidated General Government Fiscal Operations**

(In percent of GDP)	2012	2013	2014	2015e	2016p	2017p	2018p	2019p
<b>Revenue</b>	<b>39.4</b>	<b>37.9</b>	<b>39.7</b>	<b>41.1</b>	<b>41.3</b>	<b>40.4</b>	<b>40.2</b>	<b>39.8</b>
Taxes	34.2	33.4	35.1	35.3	35.6	35.4	35.3	35.1
Personal income tax	4.6	4.0	3.7	3.7	3.7	3.7	3.7	3.7
Social security contributions	10.6	10.8	11.3	11.2	11.2	11.3	11.4	11.3
Corporate income tax	1.5	1.6	1.9	1.6	1.5	1.5	1.5	1.5
Value-added taxes	10.3	9.8	10.5	10.5	10.5	10.4	10.4	10.5
Excises	5.1	5.3	5.4	5.9	6.3	6.1	6.0	5.9
Taxes on international trade	1.0	0.8	0.8	0.8	0.9	0.9	0.8	0.8
Other taxes	1.2	1.1	1.5	1.6	1.6	1.5	1.5	1.5
Non-tax revenue	5.0	4.2	4.4	5.6	5.4	4.8	4.6	4.5
Capital revenue	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Grants	0.1	0.1	0.2	0.2	0.3	0.2	0.3	0.2
<b>Expenditure</b>	<b>46.6</b>	<b>43.5</b>	<b>46.3</b>	<b>44.8</b>	<b>43.7</b>	<b>42.5</b>	<b>41.8</b>	<b>41.4</b>
Current expenditure	42.5	40.8	42.7	41.1	39.9	38.4	38.0	37.6
Wages and salaries	10.5	10.1	9.9	9.0	8.7	8.1	8.0	7.8
Goods and services	8.0	7.2	7.9	7.6	7.9	7.6	7.6	7.7
Interest	1.9	2.4	2.9	3.3	3.5	3.4	3.6	3.6
Subsidies	4.1	3.3	4.0	3.4	2.7	2.5	2.5	2.5
Transfers	18.1	17.7	17.8	17.9	17.2	16.7	16.3	16.1
Pensions	13.2	12.8	13.0	12.3	12.1	11.6	11.2	11.1
Other transfers	4.8	4.9	4.8	5.5	5.1	5.1	5.1	5.0
Capital expenditure	3.3	2.1	2.5	2.9	3.0	3.4	3.4	3.4
Net lending	0.5	0.3	0.4	0.1	0.1	0.1	0.1	0.1
Amortization of activated guarantees	0.3	0.2	0.8	0.8	0.8	0.7	0.3	0.3
<b>Fiscal balance (incl. amortization of called guarantees)</b>	<b>-7.2</b>	<b>-5.6</b>	<b>-6.6</b>	<b>-3.7</b>	<b>-2.5</b>	<b>-2.2</b>	<b>-1.7</b>	<b>-1.6</b>
Primary fiscal balance	-5.3	-3.2	-3.7	-0.5	1.0	1.3	1.9	2.0

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

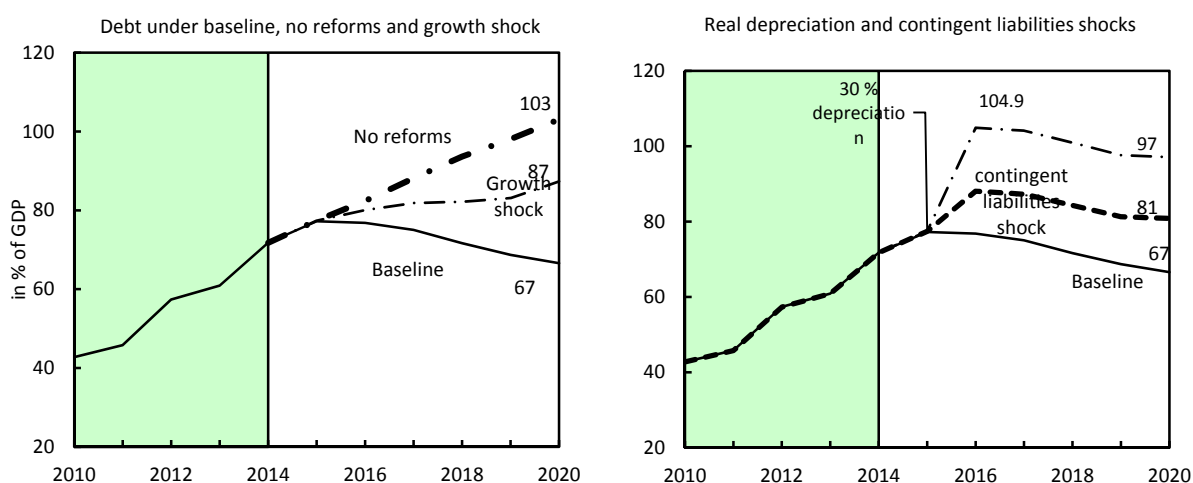
22. **Implementation of the Government's ambitious fiscal consolidation and structural reforms program will support a stabilization of the public debt ratio and put it on a downward trajectory.** As mentioned, the fiscal consolidation program focuses on reducing public sector wage bills and pension costs, along with a reduction in fiscal support to public enterprises, in conjunction with broad-ranging structural reforms. In 2016, further fiscal adjustment is targeted beyond the already significant achievement in 2015. The approved 2016 budget aimed to keep the general government deficit at a similar level to 2015 (around 4 percent of GDP), but results from the year-to-date suggest that annual deficit will be most likely around 2.5 percent of GDP. Over the medium-term, the fiscal deficit is projected to fall to around 2 percent of GDP with government spending declining from 46.7 percent in 2014 to 42.6 percent of GDP by 2017, mostly through cutting recurrent spending (the wage bill and pensions). Progress on government rightsizing and subsidy reforms in particular will be key to delivering the targeted consolidation in 2016 and 2017. The revenue-to-GDP ratio will increase only marginally despite the projected positive economic growth (from 39.7 percent of GDP in 2014 to 40.4 percent in 2017), as exports and investments, the main drivers of growth, are not seen as helping revenues (e.g. VAT) significantly.



23. **Under the baseline scenario, public debt-to-GDP is projected to fall from its peak of 77.2 percent at end-2015 to under 70 percent by 2019.** Under the baseline macro scenario, assuming the fiscal consolidation strategy is implemented as planned through completion of the IMF program in 2017, the primary balance will improve from -3.7 percent of GDP in 2014 to a 2 percent surplus in 2019. However, given the high initial level of debt, even with this fiscal consolidation, public debt-to-GDP will remain high over the projection period, declining below 70 percent only by 2019. The government's gross fiscal financing needs will also remain significant, of the order of 14-18 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.** In terms of the debt profile, only around 22 percent of central government debt is variable interest rate, with 78 percent fixed. Most public debt is external direct debt (39.3 percent of GDP) while domestic public debt accounts for 26 percent of GDP as of end-May 2016. Foreign-currency debt is high, with only 21 percent denominated in local currency, 40 percent in euro and 33 percent in US dollars. With a high share of foreign currency-linked liabilities, a sharp real depreciation would move the debt ratio up markedly. Both slippages in fiscal consolidation progress and lower-than-anticipated GDP growth (compared to the baseline) could also lead to the debt ratio continuing to rise through the projection period.

**Figure 1: Serbia: Public Debt Sustainability<sup>1,2</sup>**



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).

25. **The macroeconomic policy framework is considered adequate for the proposed operation.** The authorities are committed to adjust the fiscal policy as needed to maintain debt sustainability over the medium term while supporting growth through structural reform progress. The macro-fiscal framework is also supported by a precautionary IMF program as discussed below. There are though significant downside risks to the macroeconomic framework, both external and internal. External risks relate to lower-than-expected economic recovery in the EU which would impact Serbia through exports, remittances and capital flows since the EU countries are Serbia's largest trading partners and investors. Higher volatility in international financial markets, for example, could also pose risks to the outlook

through financial channels given Serbia's refinancing needs and foreign currency debt burden, and also via real channels through their potential spill over to external demand. A deterioration of the financial situation of foreign parent banks could similarly jeopardize credit recovery and undermine growth. Key domestic risks arise from the implementation of the fiscal reform program. If some of these risks were to materialize, the government would need to undertake even greater fiscal consolidation efforts to ensure that public debt remains sustainable. To mitigate these risks, the government is working closely with IFI partners including the Bank and the IMF to ensure that key fiscal reforms (for example, on public administration, SOEs and public utilities) remain on track.

### C. IMF RELATIONS

26. **The Executive Board of the IMF approved a three-year, SDR 935.4 million (about €1.2 billion, 200 percent of quota) Stand-By Arrangement (SBA) for Serbia on February 23, 2015.** 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, Fund and the authorities have worked in close cooperation, for example, with the Bank working collaboratively in providing upstream inputs on public administration reform and public enterprise restructuring as part of the design of the SBA; and in helping the government develop a clear, time-bound restructuring plan for public enterprises and to complete functional reviews of certain line ministries. Most recently, the Fund completed its fourth and fifth review of the pre-cautionary SBA on August 31, 2016.

### III. THE GOVERNMENT PROGRAM

27. **The Government's economic policy program is strategically oriented towards accelerating the EU integration process.** Serbia obtained 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 implementation of economic reforms and fulfillment of the political and economic criteria set by the Council of Europe in Copenhagen, as well as fulfillment of 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. 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 two Acquis chapters were opened on December 14, 2015, and two more chapters were opened on July 18, 2016.

28. **The Government's economic program defined in the *Fiscal Strategy for 2016-18* focuses 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.<sup>2</sup>** These goals will be achieved primarily through continuation of fiscal consolidation measures, many of which were set out in the 2015-17 Fiscal Strategy, along with an acceleration of structural reforms to remove

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<sup>2</sup> Government of Serbia, "Fiscal Strategy for 2016 with projections for 2017 and 2018, adopted by the government on November 28<sup>th</sup>, 2015. The annually adopted Fiscal Strategy contains the objectives and guidelines of the Government's economic and fiscal policy for the medium-term covered by the Strategy, including an overview of priority financing areas and the medium-term expenditure framework of the budget of the Republic of Serbia, covering the next budget year and the subsequent two years.

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 SOEs and companies in restructuring; strengthening public finance management; reforms of the pension, healthcare, and education systems; strengthening financial stability. In addition, the Fiscal Strategy provides an overview of priority financing areas, the medium-term expenditure framework, and the (public) debt management strategy.

29. **The reform of SOEs 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 grouped as: (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 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 SOEs reform will help unleash private sector investment, contributing to private sector-led growth and share prosperity.<sup>3</sup>

30. **Overall, public sector enterprises make significant net losses, which in 2014 amounted to more than 3 percent of GDP or approximately EUR1.2 billion, and require significant state support to remain afloat.** Losses are spread across all types of public sector enterprises.<sup>4</sup> 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.

#### IV. THE PROPOSED OPERATION

##### A. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

31. **The proposed operation would be the second in a programmatic series of two operations supporting Government of Serbia's structural reform program for the SOEs sector, which is at the core of GoS' economic program for 2015-18.** The development objectives of the series are to reduce state participation and level of direct and indirect support to the real sector, enhance SOEs 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 by supporting measures organized in the following three pillars: (A) accelerating the restructuring and divestiture program for the

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<sup>3</sup> More details on the role of SOEs in Serbia's economy, their performance and related fiscal impact are provided in the Program Document for the first operation in the series ("First Programmatic State Owned Enterprises Reform Development Policy Loan", Report No. 67435-YF)

<sup>4</sup> There are few individual exceptions, most notably Telekom, which in 2014 had net profits of EUR140 million.

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 SOEs; and (C) mitigating the social and labor market impact of the SOEs reform program. Although the resolution of SOEs will have negative employment impact in the short term, the Government views it as the central part of the broader fiscal consolidation efforts. Over the medium term, these reforms will free up public resources to increase productive public investment; combined with other reforms from the economic program, the SOEs reforms will also contribute to improved investment climate.

32. **This operation is fully congruent with the 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 investments 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).

33. **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, and it is critical that these champions clearly articulate the benefits of reform to the public. Also, given the strong vested interests involved, improving SOEs 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**

34. **Authorities have made good progress with the implementation of the program.** This includes a solid track record in implementing the most challenging reforms related to the resolution of the PA portfolio: as of end-August 2016 out of 140 PA companies that were in restructuring as of August 13, 2014, 98 have been resolved. In total, almost 24,000 workers (about 20,000 in 2015 and almost 4,000 in 2016) received compensation packages from the Transition Fund and left the companies (including almost 15,000 workers from companies previously in restructuring). Demonstrating their commitment to completing the privatization process, the authorities have shut down the Privatization Agency (PA) at the

end of 2015. The Bankruptcy Unit of the PA, with about 80 staff, was merged with the Bankruptcy Supervision Agency (ALSU) in October 2015. Some of the remaining 200 PA staff were moved to the Ministry of Economy in January 2016 to finalize the remaining privatizations and monitor the contracts for earlier privatizations. In terms of structure of the operation, most of the triggers as defined at the approval of the first operation have been fully retained and converted to prior actions. The prior actions and progress on implementation are summarized in Table 4.

**Table 4. Indicative Triggers from DPL1 and Prior Actions for DPL2**

Indicative Triggers	Retained Prior Actions
<p><b>Trigger # 1:</b> Out of 140 PA companies that were in restructuring as of August 13, 2014, at least 100 have been resolved.</p>	<p><b>Prior action # 1:</b> The Borrower has taken the following actions for at least ninety seven (97) PA Companies that were in the status of restructuring as of August 13, 2014: (a) through its Privatization Agency, Ministry of Economy, and Bankruptcy Supervision Agency: (i) established the privatization model and methods to be used for each PA Company to be privatized, and successfully privatized each such PA Company as evidenced by the finalized privatization contracts signed by the respective investors and the Borrower; or (ii) initiated formal bankruptcy proceedings with the relevant courts for those PA Companies that could not be privatized; (b) through the relevant PA Companies, prepared pre-packaged reorganization plans that have been accepted by the PA Companies' respective creditors and have been sanctioned by the relevant courts.</p> <p><i>Comment: No substantial change.</i></p>
<p><b>Trigger # 2:</b> For PA companies that were not in restructuring as of August 13, 2014, public bids were announced for at least 20 PA companies.</p>	<p><b>Prior action # 2:</b> The Borrower, through its Privatization Agency, issued Public Announcements for at least twenty (20) public bids for PA Companies that were not in restructuring as of August 13, 2014.</p> <p><i>Comment: No substantial change.</i></p>
<p><b>Trigger # 3:</b> Ministry of Agriculture and Environmental Protection has assessed the potential environmental damages for at least 180 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.</p>	<p><b>Prior action # 3:</b> The Borrower, through its Ministry of Agriculture and Environmental Protection: (a) selected a subset of the PA Companies, and companies in bankruptcy for which the PA was serving as the bankruptcy administrator, that were determined to present environmental risks; (b) assessed the potential environmental damages and the estimated volume of hazardous waste for this subset of companies; and (c) Initiated the disposal and treatment of the related hazardous waste.</p> <p><i>Comment: Strengthened. In addition to estimating volumes of legacy hazardous waste at sites of the companies, the revised Prior Action includes initiating the process of the disposal and treatment of hazardous waste.</i></p>
<p><b>Trigger # 4:</b> 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.</p>	<p><b>Prior action # 4:</b> The Borrower adopted the Law on Public Enterprises to strengthen the regulatory framework for monitoring, and ensuring the accountability and transparency, of Public Enterprises, including for corporatized enterprises that are subject to the Law on Public Enterprises.</p>
<p><b>Trigger # 5:</b> Adopt legal framework to ensure full congruency so that corporatized SOEs are adequately monitored and maintain high standards of transparency and disclosure.</p>	<p><i>Comment: The two triggers have been combined. The authorities have completed thorough amendments to the PE Law (an alternative considered was to address one of the triggers through a by-law).</i></p>

<p><b>Trigger # 6:</b> 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.</p>	<p><b>Prior action # 5:</b> The Borrower, through the decisions of the supervisory boards of the respective Public Enterprises, established audit committees in at least twenty (20) Public Enterprises that are subject to the Law on Public Enterprises and of which the founder is the Republic of Serbia.</p> <p><i>Comment: The original target could not be reached due to restructuring of individual companies, which delayed establishing Audit Committees in these cases.</i></p>
<p><b>Trigger # 7:</b> 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.</p>	<p><b>Prior action # 6:</b> The Borrower, through its Ministry of Labor, Employment, Veteran, and Social Affairs and its National Employment Service (“NES”) improved the design and targeting of the Public Works program by: (a) prioritizing applications from persons who are deemed redundant, unskilled, or hard-to-employ; (b) restricting the scope of public works to social and humanitarian activities and to the maintenance and refurbishment of public infrastructure and preservation of the environment; and (c) limiting the payment of remuneration to RSD 15,000 per person per month under a casual employment contract.</p> <p><i>Comment: The wording of the prior action has been revised to detail the improvements in the design and targeting of public works.</i></p>
<p><b>Trigger # 8:</b> 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.</p>	<p><b>Prior action # 7:</b> Dropped.</p> <p><i>Comment: The report was prepared in January 2016. Further analytical work is needed before specific policy recommendations can be formulated, and the effect of those measures will fall outside of the time frame of this operation. As reflected in the Letter of Development Policy, authorities committed to follow up work which will be led by an inter-ministerial working group established as part of the reforms supported by the Competitiveness and Jobs project.</i></p>

#### **Pillar A- Accelerating the restructuring and divestiture program for the Privatization Agency portfolio and selected state owned enterprises operating in the commercial sector**

35. **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.** This will be achieved primarily by resolving the most problematic part of the Privatization Agency portfolio, the companies which were previously in restructuring status. *Expected results:* 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, and the accumulation of arrears to public utilities. These savings will free up public resources for more productive use. Baseline and target values are detailed in the Policy and Results Matrix (Annex 1).

*Prior action #1: The Borrower has taken the following actions for at least ninety seven (97) PA Companies that were in the status of restructuring as of August 13, 2014: (a) through its Privatization Agency, Ministry of Economy, and Bankruptcy Supervision Agency: (i) established the privatization model and methods to be used for each PA Company to be privatized, and successfully privatized each such PA Company as evidenced by the finalized privatization contracts signed by the respective investors and the Borrower, or (ii) initiated formal bankruptcy proceedings with the relevant courts for those PA Companies that could not be privatized; through the relevant PA Companies, prepared pre-packaged reorganization plans that have been accepted by the PA Companies’ respective creditors and have been sanctioned by the relevant courts.*

36. **The resolution of the Privatization Agency portfolio is advancing broadly as planned.** The most problematic part of the PA portfolio are companies which were in the status of restructuring (as of August 13, 2014 there were 140 of these companies with about 46 thousand workers). Under the previous Law on Privatization, they had open ended protection from enforcement by creditors. With the new Law on Privatization (adopted as part of reforms supported by the first operation), this protection expired as of end-May 2015. To avoid disorderly winding down of these companies as the protection expired, the authorities have segmented the companies that were in restructuring into different groups based on the number of workers they employ, viability of their business, their importance for the economies of local communities, and on the complexity of legacy legal issues these companies are facing. In parallel with resolving the companies, the authorities are proceeding with offering financial assistance packages from the Transition Fund to redundant workers. As of end-August 2016, over 15,000 workers had taken the packages and left the companies. There are about 22,000 workers left in the unresolved companies from this group, of which the large majority are in the remaining strategically important companies and in the seven companies located in Kosovo (about 13,000 and 7,000 workers respectively). As of end-August 2016, a total of 98 companies had been resolved (i.e. either privatized or the bankruptcy process initiated). Details for the different groups of companies that were in restructuring are as follows:

- a) 36 companies are part of the broader Action Plan for 188 PA companies with no viable business, to be put to bankruptcy. Of these, 32 companies have been resolved (as of end-August 2016) through bankruptcies being initiated. In addition, three companies from this group filed pre-packaged bankruptcy plans with the courts and these are to be voted on by the creditors, and for one company possible privatization is being discussed. Originally companies from this group employed a total of 2,756 workers, of which 2,224 workers already applied, qualified and received the TF packages and left the companies.<sup>5</sup>
- b) 37 companies with potentially viable business which managed to sufficiently resolve legacy legal issues to announce public bids for privatization prior to end-May 2015; for these companies protection from creditors was conditionally extended until completion of the bidding process or until October 31, 2015, following which this group of companies also lost protection from the creditors. From this group, 29 companies have been resolved (five companies were privatized; for 19 companies bankruptcy process has been initiated; for five companies pre-packaged bankruptcy plans were adopted by the courts and are being implemented) as of end-August 2016. In addition, one company has filed pre-packaged bankruptcy plans with the courts and these are to be voted on by the creditors. Remaining seven companies from the group continue to operate, though they remain exposed to creditors' claims; most of them will likely end up in bankruptcy once they complete the social programs. Originally companies from this group employed a total of 5,890 workers, of which 2,231 already applied, qualified and received the TF packages and left the companies.
- c) 43 companies which did not manage to announce public bids for privatization lost protection from creditors on May 31, 2015. Of these, 31 have been resolved (for 27 companies bankruptcy has been initiated, for three companies pre-packaged bankruptcy plans were adopted by the courts and are being implemented, and for one company the ownership is being transferred to the

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<sup>5</sup> Not all of the workers used the TF packages. A number of companies remain operational (this applies to other groups, i.e. b) to e)) and they retain some workers. Further, in cases of bankruptcies, small number of workers can stay with the companies through the process, in particular in cases of pre-packaged bankruptcy. Finally, workers who previously received TF packages are not eligible to receive them again.

workers) as of end-August 2016. For two companies (including a local district heating company) the privatization process has been cancelled. The remaining 10 companies continue to operate and are believed to be paying current obligations (wages, taxes, utility bills), albeit they are not able to service old debt. Most of them will likely end up in bankruptcy or pre-pack bankruptcy once they complete the social programs; a few of them are trying to negotiate different solutions with the creditors. Originally companies from this group employed a total of 8,822 workers, of which 6,369 already applied, qualified and received the TF packages and left the companies.

- d) For 17 strategically important companies<sup>6</sup> protection from creditors was initially extended for one year, until end-May 2016. From this group, as of end-August 2016 six companies have been resolved (for four companies bankruptcy has been initiated, for two companies pre-packaged bankruptcy plans were adopted by the courts and are being implemented). Eleven remaining companies from this group lost protection from creditors at end-May 2016, though in several of them the state is by far the largest creditor. Of these, six companies have filed pre-packaged bankruptcy plans with the courts which will be voted on by the creditors, and in five companies efforts are ongoing at reorganizing and attempting to privatize. Originally companies from this group employed a total of 21,950 workers, of which approximately 4,500 already applied, qualified and received the TF packages and left the companies.
- e) For seven companies based in Kosovo (total of 6,891 workers), protection from creditors was also extended until end-May 2016; their resolution is subject to a separate political resolution process.

*Prior action #2: The Borrower, through its Privatization Agency, issued Public Announcements for at least twenty (20) public bids for PA Companies that were not in restructuring as of August 13, 2014.*

**37. The authorities are aiming at resolving most of the rest of the PA portfolio by the end of the year 2016.** By contrast with companies in restructuring, these companies did not pose immediate fiscal risks and their disposition is motivated by authorities' decision to limit direct involvement in economic activities which are not deemed strategic and could be carried out by private sector. The series supports this effort by focusing on launching the process and without imposing a deadline for completion to avoid undermining authorities' negotiating position. Significant progress has been made in the past year, with about 200 companies resolved and the number of remaining companies down to about 180 companies employing some 45 thousand workers. Companies were resolved through various methods, including privatization through public bidding (meeting the prior action), merging of local companies with Republican level companies (for instance in the case of local water management companies), or bankruptcy (including local media companies which according to the Media Law needed to be privatized or liquidated). The companies remaining in the portfolio are expected to be resolved mostly through privatizations on a case by case basis. These include about 50 companies with social ownership. According to the Privatization Law, if these are not privatized by the end of 2015, liquidation will be initiated.<sup>7</sup>

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<sup>6</sup> The list of strategically important companies was adopted by the Government in May 2015. The criteria for selecting these companies included large number of workers, importance for the economy of local communities and viability of business.

<sup>7</sup> There are also 12 companies based in Kosovo, which will be resolved on a separate track.



Prior action #3: The Borrower, through its Ministry of Agriculture and Environmental Protection: (a) selected a subset of the PA Companies, and companies in bankruptcy for which the PA was serving as the bankruptcy administrator, that were determined to present environmental risks; (b) assessed the potential environmental damages and the estimated volume of hazardous waste for this subset of companies; and (c) Initiated the disposal and treatment of the related hazardous waste.

38. **The authorities are aware of the importance of environmental issues for successful completion of the privatization process.** To facilitate the resolution of the PA portfolio, the authorities have identified a set of companies which could potentially present environmental liabilities. A total of 190 companies were considered, and 70 companies have been deemed risky and subject to detailed inspection by the Ministry of Agriculture and Environmental Protection. A report assessing the potential environmental damages, and cost estimates for addressing them, has been prepared by the Ministry.<sup>8</sup> The report includes, for each of the 70 companies, estimates of the volume of hazardous waste present on site, types of waste, and description of storage conditions. Based on the findings of the report, the Ministry has initiated the disposal and treatment of hazardous waste<sup>9</sup>. The cleanup has been completed in eight companies and a total of approximately 2,000 tons of hazardous waste (out of an estimated total of 5,030) has been removed.<sup>10</sup>

#### **Pillar B - Strengthening governance, regulatory and institutional framework, and monitoring and transparency arrangements for state owned enterprises**

39. **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. *Expected results:* 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.

40. **Poor operational and financial performance in the SOEs sector is driven primarily by weak monitoring and corporate governance arrangements, linked to political influence in the decision making and operations of SOEs.** The SOEs 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,

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<sup>8</sup> Report on the Hazardous Waste in Companies in Restructuring or Bankruptcy, November 2014.

<sup>9</sup> RSD 400 million from the 2015 Budget has been allocated for this purpose; due to overall fiscal consolidation, lower amount has been allocated in the 2016 Budget, but it will allow for the activities to continue. The work that has been initiated to dispose and treat hazardous materials has been addressed by the Expert Committee established by Ministry of Agriculture and Environmental Protection in its Concluding Report dated November 24, 2015.

<sup>10</sup> The actual volume of waste is actually likely to be significantly higher based on the experience from the companies where the cleanup process has been completed.

undermines ownership focus and diffuses accountability. Further, the PE Law which was in place until December 2012 had major shortcomings related to corporate governance.<sup>11</sup>

41. **A new Law on Public Enterprises, and subsequent by-laws, were adopted as part of the reforms supported by the first operation in the series.** This legal framework included provisions addressing many of the major weaknesses of the previous Law. However, some gaps remained, in particular with regards to the monitoring of public utilities that corporatize. To address these, further amendments to the legal framework are supported by the second operation.

42. **Dialogue around this pillar has also created opportunities for an in-depth Bank engagement with the four largest utilities in energy and transport.** A separate DPL series is currently being prepared (Serbia Public Expenditures and Public Utilities DPL, PEPU DPL). In addition to a pillar supporting broader public expenditure management reforms, the PEPU DPL series will have a pillar on energy sector SOEs which will be centered on reforms of power company EPS and gas company Srbijagas; and a public transport companies' pillar, which will support reforms of the Railroad company and Roads of Serbia company.

*Prior action #4: The Borrower adopted the Law on Public Enterprises to strengthen the regulatory framework for monitoring, and ensuring the accountability and transparency, of Public Enterprises, including for corporatized enterprises that are subject to the Law on Public Enterprises.*

43. **To further consolidate the improvements to the PE corporate governance framework, the authorities amended further the legislative framework for public enterprises.** After three years of implementation of the PE Law from December 2012, the authorities are addressing some of the shortcomings that emerged in practice. A revamped Law on Public Enterprises (PE Law) was drafted during the last quarter of 2015, and adopted by the Parliament in February 2016.<sup>12</sup> This new PE Law introduced improvements in several key areas, including with respect to:

- a) Responsibility for monitoring PEs, one of the main weaknesses of the existing Law, which will no longer be diffuse and fragmented between many different line ministries but concentrated at the Ministry of Economy.
- b) Strengthening mechanisms for monitoring and oversight of the PEs, in particular the corporatized ones. Overall the revised PE Law clarifies when the various corporate governance provisions from the PE Law apply, as opposed to applying the corporate governance provisions from the general Company Law. This is especially important since it reduces regulatory uncertainty for PEs which have been corporatized.
- c) Strengthened accountability of General Managers. The revised PE Law provides clearer performance evaluation mechanisms as well as criteria for dismissal. Further, loopholes regarding the appointment of Acting Managers have been addressed, and a person can serve as an Acting Manager only up to one year (currently the possibility to extend the acting status, is being used to circumvent the requirement for a public selection process).

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<sup>11</sup> 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.

<sup>12</sup> Official Gazette 15/2016.

- d) Removing ambiguities in the public selection process for the General Managers, notably regarding the process of short listing candidates, and the roles of different ministries and other institutions. Also, criteria for selection of General Managers and Board Members have been further developed.
- e) The Audit Committee which, in line with good international practice, will be chaired by the independent Board Member.

44. **Going forward, the authorities should consider creating a single specific unit (within or attached to the MoE), designated to exercise the state ownership rights.** In line with good practice this would further centralize and consolidate the oversight and management of SOEs. This unit could help to set PE objectives and targets, develop relevant performance indicators, review performance (including through benchmarking), report on performance at the aggregate level (including to the public and Parliament) and ensure adequate disclosure and transparency at the enterprise level. In addition, this unit would have a role to play in identifying, costing, and funding public services and special obligations, and to help manage the process through which state support is given.

*Prior action #5: The Borrower, through the decisions of the supervisory boards of the respective Public Enterprises, established audit committees in at least twenty (20) Public Enterprises that are subject to the Law on Public Enterprises and of which the founder is the Republic of Serbia.*

45. **The second operation will continue to support the implementation of the new accounting and auditing legal environment in state owned enterprises.** The Law on Accounting and Law on Auditing enacted in July 2013 are important steps towards the effective introduction of international standards and the transposition of the *Acquis Communautaires* in financial reporting and audit. 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, by requiring that audit committees be established in all of them. This was completed for almost all of them, albeit following the recent organizational changes in some of the public utilities (e.g. the Railroads company which in August 2015 was split in four separate legal entities for cargo, passenger transport, infrastructure maintenance and asset management; EPS electricity company has been reorganized in July 2015 by replacing previous organization through 14 legal entities with a new structure of the parent company and two subsidiaries; Srbijagas is undergoing a reorganization and unbundling of the company) the audit committees will have to be re-established in each of the new legal entities. Further efforts, beyond the duration of the series, will be needed to expand this to effectively implement the new legal environment for all state-owned enterprises, including at the municipal level.

#### **Pillar C – Mitigate the social and labor market impact of SOEs reform program**

46. **Measures supported under this pillar will seek to mitigate the short-term labor and social impacts of resolution of the companies from the PA portfolio.** The specific objectives are: (i) to ensure adequate financial protection of redundant workers of companies from the PA portfolio; 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. Sustained and adequate funding of the social impact mitigation programs throughout the series will be critical. *Expected results:* Financial assistance to affected workers will help cushion the short term impact of job losses and improved design of public works programs will provide an additional safety net.

47. **As part of policies supported by the first operation, the authorities allocated adequate financial resources to support redundant workers.** The Government has created a special budget-financed fund, the Transition Fund, which provides several options for financial assistance from which redundant workers can choose in lieu of severance pay. These options have been re-designed during the first operation to provide adequate and fiscally sustainable compensation to redundant workers<sup>13</sup>. In the 2015 Budget, RSD 16 billion (approximately EUR 130 million) was allocated to the Transition Fund, which could compensate about 20,000-25,000 redundant workers, in line with the authorities' divestiture program, while also providing sufficient resources to continue payments under previous commitments. During 2015 the Transition Fund financed compensation packages in the amount of RSD 11.1 billion for about 19,800 redundant workers.<sup>14</sup> Hence, the government has already significantly exceeded the operation's target of at least 10,000 redundant workers having access to the packages for 2015. The 2016 Budget includes an allocation of further RSD 6 billion for the Transition Fund (lower than the 2015 Budget, but this is because most of the severances were completed in 2015). As of end-August 2016, RSD 2.3 billion had been used to finance compensation packages for 3,700 redundant workers this year.

48. **In addition, the National Employment Service (NES) improved its services for redundant workers.** As part of the first operation, the NES changed its policies and rules to: (i) visit every company that plans to lay off more than 10 workers and inform workers about available NES services; (ii) contact at least 20 employers in the same and neighboring municipalities where the company resides to inquire about job vacancies; and (iii) consult with the local employment council about support for redundant

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<sup>13</sup> The main package offers financial compensation as foreseen in the labor code, only taking into account work history with the last employer. This package is deemed adequate and ensures equity between redundant workers in the public and private sector. In addition, a package of EUR 200 per year of service is being offered for the entire work history. 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 a 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, many 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).

<sup>14</sup> The government confirmed that almost all workers made redundant from companies in the portfolio of the Privatization Agency (PA) during 2015 received financial compensation from the Transition Fund. The only exception were 12 workers from three small media companies who failed to accept financial compensation before their companies were excluded from the PA portfolio (and hence the possibility to receive financial compensation from the Transition Fund). These workers did not accept financial compensation in the hope that their companies will continue to operate despite a failed privatization process. These workers were offered various opportunities to revise their decision to not accept a packages throughout the entire privatization process, even after the privatization process was officially declared failed for lack of interest. In addition, 28 state and socially owned companies for professional rehabilitation and employment of persons with disabilities are excluded from privatization process and therefore access to the Transition Fund. Out of these, six are subsidiary companies to companies from the PA portfolio. These six companies are facing difficulties since bankruptcy proceedings have been initiated for their parent companies, and they are unable to operate on their own. Addressing this issue, Governmental Decree was amended in February 2016 in order to grant access to the Transition Fund for the employees of these 6 subsidiary companies. Following the same logic, another amendment of the said Decree is in process, in order to include subsidiary companies to companies from the PA portfolio to be resolved through bankruptcies, and state and socially owned companies for professional rehabilitation and employment of persons with disabilities. This will allow all the employees to access the social programs in case of bankruptcy.

workers. During 2015, NES has visited 193 companies with more than 10 redundant workers from the PA portfolio and visited a further 12 companies during the first half of 2016. As a result of these visits, about 4,700 (1,600 women) individual action plans have been completed in 2015, and further 3,600 (1,400 women) in the first half of 2016. NES had collected a total of 72,000 new vacancies in 2015 and 40,000 in the first half of 2016, partially through visits in almost 800 companies in 2015 (further 290 visits were made in the first half of 2016) in the geographic neighborhood of SOEs, which represents a significant increase compared to 2014. In addition, cooperation with 65 local employment councils have been established (out of this, 52 are in municipalities with companies from the privatization agency portfolio on their territory).

49. **With funding for redundancy packages secured and NES outreach to redundant workers improved, the focus for the second operation is shifting towards measures that could facilitate transition into employment for redundant workers and offer an additional safety net in the medium run for redundant workers who become long-term unemployed.** Policies supported by the second operation aim to provide an additional safety net in the form of public works for those redundant workers who cannot find work and eventually become long-term unemployed. In addition, the DPL supports an assessment of how low-paying work can become more viable in the formal sector in Serbia, addressing an important barrier for re-employment of redundant workers from the SOEs. Importantly, the SOEs DPL series is complemented by a separate Competitiveness and Jobs project, which specifically aims to facilitate job creation and to strengthen the capacity of the NES.

*Prior action #6: The Borrower, through its Ministry of Labor, Employment, Veteran, and Social Affairs and its National Employment Service improved the design and targeting of the Public Works program by: (a) prioritizing applications from persons who are deemed redundant, unskilled, or hard-to-employ; (b) restricting the scope of public works to social and humanitarian activities as well as maintenance and refurbishment of public infrastructure and preservation of the environment; and (c) limiting the payment of remuneration to RSD 15,000 per person per month under a casual employment contract.*

50. **The government has adjusted the design of its public works program so that it can better serve as an additional safety net for vulnerable groups, including redundant workers.** This operation supports the re-design of the public works program to ensure these programs are self-targeted by paying less than minimum wage. The redesigned public work program - as reflected in the Public Tender for Public Works, published in the Poslovi Journal of the Borrower's National Employment Service issue 638 dated September 9, 2015:(i) pay a contractual fee below minimum wage to participants; (ii) are limited to less-than-full-time tasks that support communal activities like, for example, elderly care, maintenance of public infrastructure, and preservation of nature; (iii) are prioritized, for beneficiaries deemed redundant, unskilled, or hard-to-employ; and (iv) are limited in duration to six months of the year per person. In the medium term, the improved public works program can provide an important additional safety net for redundant SOEs workers. Public works is of particular importance because it gives the hard-to-employ, 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 of 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 increased 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. In a World Bank assessment from 2015, the existing safety net (Social Financial Assistance) was found to cover only about 3 percent of the

total population.<sup>15</sup> Because of various exclusionary eligibility criteria (e.g. in addition to income criterion, there are additional filters such as size of the claimant's dwelling, land ownership, and other assets) many of the poor did not qualify for social financial assistance. As a result, Social Financial Assistance (SFA) benefits go to only 11 percent of the poorest quintile. Hence, providing additional income opportunities for long-term unemployment, at least for some months of the year, will strengthen the overall safety net, including for redundant workers from SOEs.

**51. Participation in public works increased considerably as a result of the supported reforms.** After the redesign of the program, 11,289 (4,937 women) registered unemployed participated in public works programs during 2015, which is a marked increase from 2014. In the first half of 2016 a further 5,046 (2,261 women) registered unemployed participated in public works programs. While former SOEs worker participants remain few, as expected given that these programs are non-discriminatory, their number is expected to increase.

**52. The government is committed to reducing disincentives for formal sector work and has completed initial work on assessing different policy options.** 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. One of those significant disincentives is the minimum social security contribution. The minimum contribution is calculated from a base set at about 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 contribution. What makes Serbia unique is that this floor is not adjusted by actual hours worked. 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 formally, but thriving informally. Also, this minimum contribution might be a significant barrier for the employment of women—often with care duties—form a significant share of part-time workers. To provide better formal employment opportunities for redundant workers as well as for other vulnerable workers and women – which are over-represented among part-time workers – the authorities are considering different policy options, including reforming the existing social security regime. To this end, the government, in consultation with the World Bank, has formed a working group, led by the Public Policy Secretariat (PPS), to assess various policy measures to encourage formal part-time work in Serbia. The PPS has completed a study assessing the impact of possible policy measures (at this stage, due to data availability, the focus has been on the supply side of the labor market) and outlining initial recommendations, including defining the areas for follow up analysis before comprehensive policy adjustments can be initiated. Yet, further analytical work is needed before specific policy recommendations can be formulated. Follow up activities will continue under a complementary World Bank operation, the Competitiveness and Jobs project (approved by the Board on September 16, 2015).

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<sup>15</sup> Republic of Serbia: Public Finance Review 2015, World Bank, 2015.

**Table 5. DPO Prior Actions and Analytical Underpinnings**

<b>Pillar A: Accelerating the restructuring and divestiture program for Privatization Agency Portfolio and selected State Owned Enterprises operating in the commercial sector</b>
<p><b>Prior action #1:</b> The Borrower has taken the following actions for at least ninety seven (97) PA Companies that were in the status of restructuring as of August 13, 2014: (a) , through its Privatization Agency, Ministry of Economy, and Bankruptcy Supervision Agency: (i) established the privatization model and methods to be used for each PA Company to be privatized, and successfully privatized each such PA Company as evidenced by the finalized privatization contracts signed by the respective investors and the Borrower, or (ii) initiated formal bankruptcy proceedings with the relevant courts for those PA Companies that could not be privatized; (b) through the relevant PA Companies, prepared pre-packaged reorganization plans that have been accepted by the PA Companies’ respective creditors and have been sanctioned by the relevant courts.</p> <p><b>Prior action #2:</b> The Borrower, through its Privatization Agency, issued Public Announcements for at least twenty (20) public bids for PA Companies that were not in restructuring as of August 13, 2014;</p> <p><b>Prior action #3:</b> The Borrower, through its Ministry of Agriculture and Environmental Protection: (a) selected a subset of the PA Companies, and companies in bankruptcy for which the PA was serving as the bankruptcy administrator, that were determined to present environmental risks; (b) assessed the potential environmental damages and the estimated volume of hazardous waste for this subset of companies; and (c) Initiated the disposal and treatment of the related hazardous waste.</p>
<p><b>Analytical Underpinnings:</b> 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), <i>Methods and Institutions – How do They Matter?: Lessons from Privatization and Restructuring in the Post-Socialist Transition</i>, in Lieberman and Kopf (ed.) <i>Privatization in Transition Economies: The Ongoing Story</i>. 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. (See <i>Report on analysis of policy, regulatory and implementation framework for addressing environmental liabilities in privatization in Republic of Serbia</i>, World Bank, June 2013, Milieu, Law and Policy Consulting).</p>
<b>Pillar B: Strengthening governance, regulatory and institutional framework, and monitoring and transparency arrangements for SOEs</b>
<p><b>Prior action #4:</b> The Borrower adopted the Law on Public Enterprises to strengthen the regulatory framework for monitoring, and ensuring the accountability and transparency. of Public Enterprises, including for corporatized enterprises that are subject to the Law on Public Enterprises;</p> <p><b>Prior action #5:</b> The Borrower, through the decisions of the supervisory boards of the respective Public Enterprises, established audit committees in at least twenty (20) Public Enterprises that are subject to the Law on Public Enterprises and of which the founder is the Republic of Serbia.</p>
<p><b>Analytical Underpinnings:</b> The prior actions (including those supported by the first operation) 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.</p>
<b>Pillar C - Mitigating the social and labor impact of the SOEs reform program</b>
<p><b>Prior action #6:</b> The Borrower, through its Ministry of Labor, Employment, Veteran, and Social Affairs and its National Employment Service (“NES”) improved the design and targeting of the Public Works program by: (a) prioritizing applications from persons who are deemed redundant, unskilled, or hard-to-employ; (b) restricting the scope of public works to social and humanitarian activities and to the maintenance and refurbishment of public infrastructure and preservation of the environment; and (c) limiting the payment of remuneration to RSD 15,000 per person per month under a casual employment contract.</p>
<p><b>Analytical Underpinnings:</b> The Poverty and Social Impact Assessment underscored the critical importance of severance packages in supporting redundant workers. The PSIA also 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.</p>

53. **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 revised 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 the Competitiveness and Jobs project. This combination of technical assistance and operational support should considerably enhance the capacity of NES to support redundant workers, improve the quality of their services and programs over the next four years, and start addressing incentives and demand for low-paying formal jobs.

### C. LINK TO CPF AND OTHER BANK OPERATIONS

54. **The SOEs DPL series is fully congruent with the Country Partnership Framework (CPF) for FY16-20 and contributes to both of its focus areas (Focus Area 1: the “Economic governance and the role of the state” and Focus Area 2: “Private sector growth and economic inclusion”).** Focus area 1 specifically addresses constraints to the effectiveness of economic governance: the size and management of the budget, the scope and capacity of the administration to implement reform and deliver services, the footprint of the government in the economy, and the performance of public utilities. The series will directly contribute to the following CPF goals in this area: *supporting sustainable public expenditure management* and *productive SOEs assets transferred to private ownership*. Focus area 2 addresses significant constraints to private sector development and economic inclusion: financing, investment, connectivity, and labor market constraints. CPF goals in this area to which the series will directly contribute include *contribute to priority business climate improvements* and *reduced barriers to labor market participation*. The series is complemented by several other Bank operations being implemented or in the pipeline. Similarly to the SOEs DPL series, both the Program-for-Results on Modernization Optimization of Public Administration and the Public Expenditure and Public Utilities DPL series are contributing to different aspects of improving economic governance and better balance between public and private sector roles in the economy. The Competitiveness and Jobs project supports reforms focusing on enhancing the effectiveness of investment and export promotion programs, developing systems to promote innovation and technology transfer and addressing barriers to labor market entry; these reforms will assist the country in its efforts to transition to an export-oriented growth model and create conditions for sustained medium term growth. The SOEs DPL series 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).

55. **The implementation of the proposed operation will be directly supported by and complemented with various TA and capacity building activities.** Such activities include: (i) separate Competitiveness and Jobs project, a results based loan, approved by the Board in September 2015, which will include support to the National Employment Service, redesign of ALMPs, redesign of social benefits to encourage formal work for types of workers likely to be made redundant as part of the SOEs 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 revision of Serbia’s Employment Strategy; (iv) an IFC technical assistance



program on strengthening the capacity and enhancing the legal framework for insolvency and debt resolution, and (v) an IFC technical assistance program on strengthening the corporate governance in SOEs.

#### **D. CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS**

56. **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 the PA portfolio was adopted after several rounds of intensive consultations – including the one which took place between October 2013 and July 2014 and led to the adoption of the new legal framework mapping out the process. The design of the series further substantially benefited from the extensive consultation process in the context of preparation of the new Systematic Country Diagnostic (SCD) and Country Partnership Framework (CPF). Various consultations took place between relevant government representatives – including MoF, MoE, and MoELVSA – and union representatives, civil society, business associations, and development partners. Some of the key conclusions that emerged from the consultation process and which shaped the design of the policies supported by the program include: importance of designing the reforms and policies in a manner that minimizes the possibilities for later reversal; ensuring that proper social policies or programs aimed at mitigating the adverse social impacts potentially caused by the transition are in place and that funding for such programs is secured; ensuring the transparency of the process, with a well-defined and enforced legal framework and regulatory framework.

57. **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 of information and participation in joint meetings with technical counterparts, which contributed to design the reform program. The IMF SBA is fully complementary and is building on several of the reforms supported by the DPL series. 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**

58. **Completing the restructuring process for the majority of PA companies and moving towards privatization for a groups of PA companies not in restructuring are expected to foster sustainable economic growth, job creation and poverty reduction, albeit there will be job losses in the short run.** Poverty reduction and shared prosperity in Serbia has closely followed economic growth, with substantial progress achieved before the global financial crisis and deterioration since the crisis. Reinvigorating economic growth is therefore necessary 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 key to sustainable improvements in welfare of the less well-off in Serbia. Overall, the sluggish progress on both growth and poverty reduction reflects a largely unfinished first-generation reform agenda to build 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 immediate job losses. The authorities estimate that for the 140 enterprises that were in restructuring as of August 2014 up to 30,000 jobs (out of total of about 50,000) could be lost. The progressive divestiture of the remaining companies in the PA portfolio is not expected to result in massive job losses, as those companies already operate on a commercial basis and without significant state support.<sup>16</sup>

59. **Given the difficulty to estimate the overall poverty impacts of the DPO 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.**<sup>17</sup> The assessment 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 that was in place in the past. The assessment underscored in particular that: (a) workers in the PA portfolio are likely to be difficult to reemploy; (b) the majority of dismissed workers appear likely to end up as occasional laborers in the informal sector; (c) despite the existence of a premium for working in the SOEs sector as compared to the private sector, workers in the PA portfolio companies enjoy smaller premia and on average are not particularly well off in terms of savings or alternative income sources; (d) the main compensation mechanism 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 workers find a new job.

60. **The series will support the strengthening of existing government mechanisms to help cushion the poverty and social impact of the reforms.** First, the authorities are committed to providing redundancy packages to all workers affected by the resolution of the PA portfolio in order to help compensate for immediate welfare losses. Second, active labor market programs are expected to partially mitigate negative impacts. The National Employment Service has designed specific measures to support potentially affected workers (e.g. the requirement for NES to visit all SOEs with 10 or more redundant workers, prepare individual action plans, and outreach to potential new employers and registering job vacancies). In addition, the direct provision of employment opportunities through public work programs, supported under the second operation in the series, is 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 only compensate a job loss, workers in the PA portfolio companies 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. Third, the government is taking other initiatives to boost overall job creation such as reforms of the business environment and innovation policy. Through the Competitiveness and Jobs Project, the Bank is supporting the government's reform efforts to address both labor demand and supply side constraints to job creation.

61. **The measures under the social pillar are also expected to address certain gender impacts and inequalities.** First, the PSIA found that gender differences that were identified in terms of impacts of redundancy or overall vulnerability mostly relate to cultural norms and expectations of men being traditional bread winners. Different parts of the focus group discussions probed participants to reflect

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<sup>16</sup> At the time of first operation there were 374 companies not in restructuring in the PA portfolio, with about 40,000 jobs.

<sup>17</sup> The PSIA is discussed in more details in the program document for the First Programmatic SOEs Reform DPL to the Republic of Serbia (World Bank Report No. 67435-YF).

directly or indirectly on gender differences. While both older workers of either gender face difficulties in finding new employment, men are more likely to feel despondent for the loss of their role as 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 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 givers for their family members. Redundancy and the way the impacts of the job 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 for formal employment for women and open up economic opportunities for them, as they are overrepresented among part-time workers, should contribute to generating further employment opportunities.

## **B. ENVIRONMENTAL ASPECTS**

**62. Overall the reform policies supported by the DPL series are not likely to have significant adverse effect on the environment, forests and natural resources.** Given that most of the companies from the Privatization Agency portfolio rely upon obsolete technologies and that a large share of them will be liquidated, or in the cases of successful privatization their equipment upgraded, the net impact on the environment could be positive. Despite this expected neutral or marginally positive impact of the series, environmental risks were identified related to past environmental liabilities. While the measures supported under Pillar A will not accelerate the accumulation of environmental liabilities - and in many cases would actually help stop such accumulation - they could put companies under the spotlight and require concrete remedial actions. Overall, the legal and regulatory framework for addressing environmental damage prior to privatization are deemed adequate, albeit implementation is frequently hampered by broader institutional and financial capacity constraints.

**63. Serbia has made progress towards alignment of its policies with the European Union environmental acquis, and further efforts are needed to strengthen the administrative capacity and implementation framework for management of environmental risks.** 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 is expected that in the process of change of ownership or of ownership structure for companies, 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. Authorities are preparing a new Law on Environmental Liabilities (LEL), which will transpose the EU Directive 2004/35/EC of 21 April 2004 and is expected to refine and clarify the institutional mechanisms to prioritize and address environmental liabilities.

64. **Authorities have taken a number of steps to address the environmental liabilities of entities undergoing privatization or restructuring under the supported program.** The Privatization Law establishes 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 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. For the others, review by the authorities concluded there were no significant environmental risks. 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 in adherence to environmental action plans and post-privatization reporting. As the authorities plan to close the PA during the first quarter of 2016, the responsibilities for oversight on the implementation of action plans and post-privatization compliance reports will be transferred to the Ministry of Economy. The MoE reiterated its commitment to ensure proper follow-up of these environmental action plans. In addition, as noted earlier and captured in prior action 3, authorities have re-assessed the potential environmental damages for targeted PA Companies in restructuring or in bankruptcy and prepared a report on the estimated volume of hazardous waste on site and initiated the disposal and treatment of hazardous waste.

### **C. PFM, FUNDS FLOW AND AUDITING ASPECTS**

65. **Based on various independent assessments of PFM performance, Serbia's PFM system is adequate to support the operation, albeit substantial fiduciary risks remain which are being effectively addressed by Government's ongoing reforms.** The ongoing improvements in the treasury system, internal audit and external audit are encouraging and are strengthening the transparency, accountability and control framework within Serbia. The assessment 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) assessment delivered to the government in October 2015. It also takes into account functional review of the MoF conducted in 2016, relevant chapters of EU Progress Reports, annual SIGMA assessments of public expenditure management and public internal financial control. The assessment also takes note of the IMF's safeguards assessment of the NBS (2011 and 2015), as well as 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.

66. **A number of reforms have been undertaken aiming to make public financial management more efficient, but there is a need for further improvements.** The Government has made efforts to strengthen

treasury operations and financial controls, legislative and institutional framework, budget classification and coverage. However, there are still additional areas that require significant attention. The 2015 Public Expenditure and Financial Accountability (PEFA) assessment identified several areas of weaknesses in the public financial management (PFM) system. These include the strengthening of ex-ante controls of commitments, in particular related to multi-annual contracts, leading to accumulation of arrears; monitoring of fiscal risks associated with arrears and state owned enterprises; the budget preparation process; lack of functioning mechanism related to public investment.

**67. The Budget System Law provides the framework for budget preparation process and fixed budget calendar.** Budgets for the coming year are adopted by the Parliament by the end of the current year. Global budgetary ceilings and their distribution to budget users are made by the Budget Department of the Ministry of Finance. In most cases supplementary budgets are passed during the year and variances of actual expenditures compared to originally approved budget exist and are assessed to be of moderate levels. The Budget System Law also requires the preparation of three-year medium term expenditure framework (MTEF). The MTEF is revised every year and included in the Fiscal Strategy. But the forecasts of macroeconomic parameters that are the basis for preparing the MTEF are often inaccurate, over-estimating GDP growth and therefore overestimating resource availability. The MTEF and projections for the two years following the budget year are not appropriately respected when entering into multi-annual commitments. Similarly, estimates and ceilings are not taken as the starting point in preparation of following years' budgets. The Budget and the Fiscal Strategy are both publicly available at the Ministry of Finance website.

**68. Execution of the budget is operated by the Treasury and established processes, controls and procedures provide sufficient assurance about the budget execution system.** The budget is executed for payments through a Consolidated Treasury Account (CTA) operated by the Treasury. Functioning of the CTA is assessed to be reliable with adequate controls instituted, and statements and reconciliations produced on daily basis. Foreign currency funds have not yet been integrated within the CTA, so foreign currency transactions are consolidated in Treasury reports only in certain intervals. Payments are done within budget appropriations (defined by either original or supplementary budget), and hard system controls exist which prevent payments to exceed annual budget appropriations by a given budget beneficiary. In terms of cash and liquidity management, each budget beneficiary is assigned with payments quota for the coming quarter which is revised every month, and similarly payments exceeding such quotas do not get processed.

**69. Financial controls have been gradually strengthened in the past few years.** 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 a 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 2014 annual financial statements of the Government (draft law on the final account) and issued modified (qualified) opinion on the financial statements. The main weakness relates to inability to confirm completeness and valuation of government's non-financial assets due to lack of reliable asset registry which is supposed to be maintained by Public Property Directorate, which is an issue that persists from the previous years. The SAI

also identified improvements needed in the systems of internal controls and compliance with public procurement law.

70. **Measures have been taken to better manage level of arrears, such as passing the Law on Late Payments in Commercial Transactions.** This has led to a decrease in the level of arrears over the past two years. Further improvements are needed, though, including with respect to the comprehensiveness and accuracy of data collection by the MoF's Macro-Fiscal Analysis Department and the Treasury. Strengthening control mechanisms for budget commitments would also contribute to decrease the burden of high arrears on the budget, improve planning and management of public funds.

71. **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. Annual independent financial audits of the NBS do not identify any significant issues either. The auditors issued clean (unmodified) opinion on the NBS financial statements for 2015. 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.

72. **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 is included in the Law on Budget for 2016.

73. **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 execution system.

74. **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 should be delivered within 30 days of the receipt of loan proceeds. No additional arrangements to mitigate fiduciary risks, such as audit, are required as the disbursement arrangements are confined to the NBS and Consolidated Treasury Account.

#### **D. MONITORING AND EVALUATION**

75. **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 Bankruptcy Supervision 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 (since January 2016 case workers have been transferred to MOE). The data collected by the PA allows the Ministry of Economy to have a strategic overview of the overall process (since January 2016 the data collection is performed directly by MOE). 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.

76. **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.

77. **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).<sup>18</sup> 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

78. **Overall risk rating for this operation is substantial and the Political and governance risk 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 high. Notwithstanding, an unwavering high level of political support remains critical for the success of the operation. 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. The overall risk is further mitigated by the ongoing IMF Stand-By Arrangement (SBA) and the parallel Public Expenditure and Public Utilities DPL (PEPU DPL) series currently under

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<sup>18</sup> Assessing the effectiveness of local grievance redress mechanisms goes beyond the scope of this operation. However, there is evidence that national mechanism are in place and are used by workers, as there have been several cases where workers successfully sued SOEs for unpaid wages/benefits.

preparation. Both the IMF supported program and the PEPU DPL are fully complementary with the SOEs DPL series and build on several of the reforms supported by the series, most notably the divestiture of the PA portfolio and improved performance of public utilities. The overall risk of backtracking is also mitigated by the successful implementation of the first operation in the series, and the demonstrated track record of implementing difficult reforms. The operation supports strengthening of governance and institutional framework for SOEs, including strengthening the selection of high level management positions. Strengthening of corporate governance in key public utilities will be further supported by the PEPU DPL series. However, even the most transparent and competitive process cannot eliminate the risk that the selected candidates end up involved in improper activities. Finally, the Bank is also supporting the authorities in communicating the benefits of the proposed reforms (e.g. public outreach through media interviews, participation in conferences, etc.) to preserve political momentum for the reform program.

79. **Substantial macroeconomic risks remain.** Although recent economic and fiscal performance has been positive, there remain substantial macroeconomics risks which could impact Serbia's macro-fiscal outlook. External risks are related to possible delays in Europe's overall economic recovery, which could hamper Serbia's growth, and hence revenue performance, through their adverse impact on exports, remittances and capital flows. A deterioration of the financial situation of foreign parent banks could similarly jeopardize credit recovery and undermine growth. Internal risks to the macro fiscal framework arise primarily from high level of public debt, and the rate of progress on some crucial but politically difficult reforms, such as public employment rightsizing, which could undermine fiscal consolidation efforts. However, such reforms are directly supported by IFI programs, including Bank operations (PforR on Modernization and Optimization of Public Administration, the SOEs DPL series and the Public Expenditure and Public Utilities DPL), mitigating the risks. The risk will be further mitigated by a close monitoring of economic and fiscal developments, and by the fact that the framework is supported by the IMF.

80. **Implementation risks are substantial.** Implementation of the proposed program will strain the capacity of public sector institutions directly involved, in particular the units in Ministry of Finance and Ministry of Economy responsible for SOEs oversight, the National Employment Services of the Ministry of Labor, Employment, Veteran and Social Affairs, and the courts handling bankruptcy cases. This risk will be mitigated by various envisaged 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; IFC TA on improving SOEs corporate governance practices; 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 Competitiveness and Jobs project, which includes a specific component on strengthening the capacity of the National Employment Service, and reforming the design of Active Labor Market Programs (ALMPs). The risks will be further mitigated by continued implementation monitoring.

81. **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.



82. **Environmental and Social risk are substantial.** The policies supported under the series are not expected to have significant adverse environmental impact, the main risks identified being related to existing (i.e. legacy) environmental liabilities and how they are dealt with in the divestiture/disposition process. 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. Recognizing the risks, the authorities have assessed 190 companies from the PA portfolio and for the 71 which were deemed risky prepared detailed assessment on hazardous waste. Disposal and treatment of this waste has been initiated. As the PA was closed during the first quarter of 2016, the responsibilities for oversight on the implementation of action plans and post-privatization compliance reports have been transferred to the Ministry of Economy. The MoE remains committed to ensure proper follow-up of these responsibilities. With respect to social risks, the resolution of SOEs will have negative short term impact on employment. Further, many of the redundant workers—particularly women and older workers whose skills may be obsolete—will find it difficult to find alternative employment and will most likely become permanently unemployed. The series includes a pillar specifically dedicated to mitigate the social and employment impact of the program. The impact will also be cushioned by complementary activities, including the Competitiveness and Jobs operation.

**Table 6.** Systematic Operations Risk Rating Tool

<b>Risk Categories</b>	<b>Rating (H, S, M or L)</b>
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	S
8. Stakeholders	L
9. Other	-
<b>Overall</b>	S

# ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions		Results
Prior Actions for DPO 1	Prior Actions for DPO 2	
<b><i>Pillar A- Accelerating the restructuring and divestiture program for the Privatization Agency portfolio and selected state owned enterprises operating in the commercial sector</i></b> <b><i>Program Development Objective A- Reduce State participation and levels of direct and indirect state support in the real sector</i></b>		
<b>Prior action #1:</b> 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	<b>Prior Action # 1:</b> The Borrower has taken the following actions for at least ninety seven (97) PA Companies that were in the status of restructuring as of August 13, 2014: (a) through its Privatization Agency, Ministry of Economy, and Bankruptcy Supervision Agency: (i) established the privatization model and methods to be used for each PA Company to be privatized, and successfully privatized each such PA Company as evidenced by the finalized privatization contracts signed by the respective investors and the Borrower, or (ii) initiated formal bankruptcy proceedings with the relevant courts for those PA Companies that could not be privatized; (b) through the relevant PA Companies, prepared pre-packaged reorganization plans that have been accepted by the PA Companies’ respective creditors and have been sanctioned by the relevant courts.	<b>Result Indicator A1</b> —Reduction of direct and indirect support to companies in Privatization Agency portfolio: <ul style="list-style-type: none"><li>- Annual direct subsidies and soft loans (million Euro):<ul style="list-style-type: none"><li>o Baseline (average 2010-2012): 85</li><li>o Target (2017): less than 5</li></ul></li><li>- New tax obligations and social contributions arrears:<ul style="list-style-type: none"><li>o Baseline (average 2010-2012): 190</li><li>o Target (2017): less than 5</li></ul></li><li>- New arrears to public utilities:<ul style="list-style-type: none"><li>o Baseline (average 2010-2012): 70</li><li>o Target (2017): less than 5</li></ul></li></ul> <b>Result Indicator A2</b> —Disposal and treatment of legacy hazardous waste generated by companies in the Privatization Agency portfolio: <ul style="list-style-type: none"><li>- Total volume of legacy hazardous that was disposed and/or treated (tons of waste)<ul style="list-style-type: none"><li>o Baseline (2014): 0;</li><li>o Target (cumulative, 2015-2017): 1,500</li></ul></li></ul>
<b>Prior action #2:</b> 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	<b>Prior Action # 2:</b> The Borrower, through its Privatization Agency, issued Public Announcements for at least twenty (20) public bids for PA Companies that were not in restructuring as of August 13, 2014.	
<b>Prior action #3:</b> 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.	<b>Prior Action # 3:</b> The Borrower, through its Ministry of Agriculture and Environmental Protection: (a) selected a subset of the PA Companies, and companies in bankruptcy for which the PA was serving as the bankruptcy administrator, that were determined to present environmental risks; (b) assessed the potential environmental damages and the estimated volume of hazardous waste for this subset of companies; and (c) Initiated the disposal and treatment of the related hazardous waste.	

<b>Pillar B - Strengthening governance, regulatory and institutional framework, and monitoring and transparency arrangements for SOEs</b> <b>Program Development Objective B - Improve performance and accountability of state owned enterprises</b>		
<b>Prior action #4:</b> 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.	<b>Prior Action # 4:</b> The Borrower adopted the Law on Public Enterprises to strengthen the regulatory framework for monitoring, and ensuring the accountability and transparency, of Public Enterprises, including for corporatized enterprises that are subject to the Law on Public Enterprises.	<b>Result Indicator B1</b> - 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 (2016, all required). <b>Result Indicator B2</b> —Reduction of direct subsidies and reduction of issuance of new guarantees for liquidity purposes for large SOEs: - Direct subsidies for recurrent expenditures (million Euro) o Baseline (average 2012-2014): 250 o Target (2017): less than 150 - Annual guaranties for liquidity purposes (million Euro): o Baseline (average 2012-2014): 265 o Target (2017): 0
<b>Prior action #5:</b> 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.	<b>Prior Action # 5:</b> The Borrower, through the decisions of the supervisory boards of the respective Public Enterprises, established audit committees in at least twenty (20) Public Enterprises that are subject to the Law on Public Enterprises and of which the founder is the Republic of Serbia.	
<b>Prior action #6:</b> 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).		
<b>Pillar C- Mitigating the social and labor impact of the SOEs reform program</b> <b>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.</b>		
<b>Prior action #7:</b> 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.	<b>Prior Action # 6:</b> The Borrower, through its Ministry of Labor, Employment, Veteran, and Social Affairs and its National Employment Service (“NES”) improved the design and targeting of the Public Works program by: (a) prioritizing applications from persons who are deemed redundant, unskilled, or hard-to-employ; (b) restricting the scope of public works to social and humanitarian activities and to the maintenance and refurbishment of public infrastructure and preservation of the environment; and (c) limiting the payment of remuneration to RSD 15,000 per person per month under a casual employment contract.	<b>Result Indicator C1:</b> Number of redundant workers receiving compensation from the Transition Fund increases from approx. 5,700 (2014) to at least 25,000 (cumulative 2015 and 2016) (to be monitored by gender) <b>Results Indicator C2:</b> At least 30 percent of workers made redundant from public enterprises during 2016 register with NES (to be monitored by gender). <b>Result Indicator C3:</b> Number of participants in public works increases from 2,882 in 2013 (1,187 female and 1,695 male) to at least 7,000 in 2016 (to be monitored by gender).
<b>Prior action #8:</b> 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.		

## ANNEX 2: LETTER OF DEVELOPMENT POLICY

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**LETTER OF DEVELOPMENT POLICY**  
**MINISTRY OF FINANCE**  
**MINISTRY OF ECONOMY**  
**MINISTRY OF LABOR, EMPLOYMENT, VETERAN AND SOCIAL AFFAIRS**  
**REPUBLIC OF SERBIA**

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

Belgrade, September 8, 2016

REF: Letter of Development Policy  
Serbia: Second Programmatic State Owned Enterprise Reform Development Policy Loan

This letter summarizes in a selective manner critical aspects of the program that the Government of Serbia is committed to undertake over the short and medium term to 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 and key structural reforms**

The Government of Serbia adopted on November 28<sup>th</sup> 2015 the *Fiscal Strategy for 2016–2018*, which outlines our economic policy for the medium-term. The main goals of our economic policy are: continuation of the fiscal consolidation measures to ensure macroeconomic stability, curb the growth of public debt and put it on a downward path; increasing the stability and resilience of the financial sector, including by resolving the issue of non-performing loans; continue implementing a comprehensive set of structural reforms to improve competitiveness and ensure sustainable economic growth, in particular through the reforms of the state owned enterprises and improving the efficiency of the public sector. The goals of the economic program are compatible with our aspirations to become an EU member, having started the accession process in January 2014.

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 are implementing an ambitious plan for fiscal consolidation and structural reforms under the ongoing three year IMF Stand-by Arrangement (SBA). The IMF SBA was approved in February 2015, and

the fourth and fifth review were successfully completed and endorsed by the IMF Board in August 2016. The program is supporting the necessary fiscal adjustment, while at the same time we are 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 Serbia.

Serbia's economy was hit hard by the international financial crisis which started in late 2008 as well as 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. However, the growth model for Serbian economy has gradually changed – from the one driven by domestic demand toward exports led growth.

Supported by the post-flood recovery of industrial production, growth has recovered over 2015. Investment and net exports are the main drivers of growth. The recent recovery in activity has been reflected in improved labor market outcomes. According to the Labor Force Survey data for Q2 2016, employment rate has reached 45.9 percent, an improvement of 3.3 percentage points compared to the same quarter last year (42.6 percent). Unemployment rate is at 15.2 percent, an improvement of 2.1 percentage points compared to the same quarter last year (17.3). Inflationary pressures have been limited by relatively weak domestic demand, lower oil import prices and, until August 2015, the absence of adjustments of administratively controlled prices. The financial system is broadly stable. The NBS is working on the resolution of the longstanding problem of non-performing loans (NPLs) under the new Action Plan for NPLs resolution (approved in August).

We expect stronger economic recovery from 2016 and onwards. Due to supportive external demand, improved investment, and gradual recovery of consumption, we project growth to move up to around 3.5 percent after 2017. Fiscal consolidation measures turned out to be less recessionary than expected. Originally projected decline of GDP by 0.5 percent in 2015 was revised to a positive growth now estimated at 0.7 percent. This turnaround was owed to a positive private sector response in both investment and wage growth which more than compensated for the reduction in pensions and public sector wages. The positive effects are expected to carry over into 2016-2017 with higher GDP growth rates now projected at 2.5 and 3.0 percent respectively. Anchored in structural reforms, significant investment revival is forecast over the program period: investment is set to rise above 20 percent of GDP. The improved external environment will also support a narrowing of the current account deficit, from 6 percent of GDP in 2014 to about 3.8 percent of GDP in the medium run, fully financed by FDI. Improved growth performance will gradually bring further improvements in labor demand and employment expansion, thus contributing to poverty reduction and shared prosperity.

Over the medium-term, we envisage a continued significant fiscal adjustment supported by the IMF program. Fiscal vulnerabilities experienced over the 2012-2014 period led to build-up of

public debt to 71.8 percent of GDP at the end of 2014. The Government put in place a fiscal consolidation program which has contributed to improved fiscal performance in 2015. The augmented fiscal deficit of the general government was reduced from 6.6 percent of GDP at the end of 2014 to below 3.8 percent at the end of 2015, compared to a 5.9 percent target set in the IMF supported program. This impressive result in the first program year was associated with an even more important 2.6 percent structural deficit improvement which sets Serbia on a sustainable deficit reduction path towards targets set in the program. This is expected to reverse the growing trend of the public debt and put it on a decline path after 2016.

This macroeconomic outlook is supported by a detailed set of reform measures introduced through annual Budget laws for 2015 and 2016. The program hinges on the reduction of the public sector wage bill, as well as progressive reduction of pensions above the subsistence minimum (25,000 dinars per month net). We remain committed to the expenditure measures introduced so far, and will continue to observe the limits set in the Budget system law for public sector wages and pensions at 7 and 11 percent of GDP, respectively, as well as reducing state aid to state-owned enterprises (SOEs).

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

- Labor Law adopted during the summer of 2014, which increases flexibility of the labor market in Serbia, by making it easier and cheaper to hire and fire workers.
- Law on Construction and Planning, adopted in early 2015, which will significantly streamline issuance of construction permits, a major bottleneck in Serbia's investment climate. New Law on Land Conversion was adopted in 2015. Proper implementation of these two laws will address most of the major concerns related to land use, administration and management.
- New umbrella Law on Inspections was adopted in April 2015. The law will improve coordination of inspections, increase predictability and transparency of their work, and put more emphasis on risk based approach to inspections.
- 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.
- We are progressing with reforms of the general government employment and wage system in 2015. In early June 2015 we established a cross-ministerial task force to strengthen the control of the public sector wage bill. In July 2015 we adopted the Law on Registry setting out the necessary data submissions and all responsible agencies, and put in place a legal framework necessary to ensure full coverage of public sector employees. The Law on Ceilings on the Number of Employees adopted in July laid the legal basis for an annual capping (2015–18) of the number of employees in individual institutions, in line with expected advancements in their productivity to be accomplished through reorganization.

We have initiated a comprehensive public wage system reform intended to improve transparency, efficiency and manageability of the currently unwieldy system. An umbrella Law on Wages of State Employees establishing the key principles of the new system and setting out a timeline for its gradual implementation is adopted in February 2016.

- 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.

Macroeconomic and fiscal developments in first half of 2016 were better than expected. Real GDP growth is revised upwards to 2.5% in 2016 and to 3% in 2017. Macroeconomic performance effected fiscal position as revenue collection is significantly better than planned which will reduce general government deficit to below 2.5% of GDP. Primary fiscal surplus will be achieved in 2016 already. Structural fiscal adjustment in previous years combined with favorable macroeconomic outlook will significantly improve fiscal position in upcoming period with faster reduction of public debt and deficit levels. New macroeconomic and fiscal medium term framework will be presented in Fiscal strategy for 2017 with projections for 2018 and 2019 which will be adopted in autumn.

#### **Program of Reforms in the SOE Sector**

The government is committed to transforming 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. 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 Portfolio**

As outlined in our *Fiscal Strategy for 2016–2018*, one of the main structural reforms that we will continue to implement 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.

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 Privatization portfolio and helped us reinstate the process of privatization for all of the companies. The 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.

We have made good progress on implementing the Law and resolving the portfolio of the Privatization Agency. To confirm our commitment, we shut down the Privatization Agency as of February 1, 2016. Vast majority of the portfolio is resolved. Responsibility for finalizing the

remaining privatizations, as well as monitoring the existing privatization contracts, is transferred to the Ministry of Economy. Responsibility for the administration of bankruptcy cases for companies that were previously under the Privatization Agency portfolio has already been transferred to the Bankruptcy Supervision Agency.

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 on Environmental Liabilities which is under preparation.

Also, we have identified a set of companies which could potentially present environmental liabilities. A report assessing the potential environmental damages and cost estimates for addressing them has been prepared by the Ministry of Agriculture and Environmental Protection, in cooperation with the Privatization Agency and Ministry of Economy. In 2015 we initiated the cleanup of hazardous waste in several of these companies.

Most problematic part of the Privatization portfolio were companies which were in the status of restructuring (as of August 13, 2014 there were approximately 140 of these companies with about 50 thousand workers). Under the previous Law on Privatization, these companies had an open ended protection from enforcement by creditors.

During 2015, to avoid disorderly winding down of these companies as the protection expired, we have segmented the companies that were in restructuring into different groups based on the number of workers they employ, viability of their business, their importance for the economies of local communities, and on the complexity of legacy legal issues these companies are facing. For each group, protection was gradually removed.

Since end of May 2016 this protection does not longer exist, when it was canceled for the last 11 companies. These companies must now operate under market conditions and meet their obligations to creditors. If not, creditors now have the possibility to initiate bankruptcy.

In parallel with resolving the companies, we are proceeding with offering financial assistance packages from the Transition Fund to redundant workers.

As of August 2016, 97 companies from this group have been resolved, mostly through bankruptcies, and we remain committed to resolving the rest. About 16,000 workers from the companies previously in restructuring have taken the packages from the Transition Fund and left the companies. There are about 22,000 workers left in these companies.

We are making good progress on resolving the rest of the PA portfolio. As of August, the rest of the portfolio includes approximately 180 companies which employ approximately 45 thousand workers. Importantly, these companies do not enjoy protection from creditors or other privileges and are in general paying current obligations (wages, taxes, utility bills). About two years ago, portfolio included 550+ companies.

Since then, more than 230 companies have been sent to bankruptcy (mostly companies with zero or small number of employees) or privatized (including approximately 30 media companies, 45 in



total). The remaining companies are expected to be resolved mostly through privatizations on a case by case basis.

Since end of 2015 bankruptcy procedure has been initiated for all companies with majority social ownership in accordance with the Privatization Law.

#### *Strengthening Governance, Institutional Framework and Transparency Arrangements for Public Enterprises*

For a group of 26 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. In parallel, we are implementing comprehensive reorganization and reform of the four largest utilities (the electricity, gas, railways, and road companies), supported by the World Bank and the EBRD.

After three years of implementation of the Law on Public Enterprises (PE Law) from December 2012, we are further improving the regulatory framework to address some of the shortcomings that emerged in practice. The PE Law from December 2012 improved many of the major shortcomings of the previous Law. However, some gaps remain and in particular with regards to the monitoring of public utilities that corporatize and further strengthening the mechanisms for ensuring accountability of the management of PEs. To address these, new PE Law has been drafted during the last quarter of 2015, and it was adopted by the Parliament in February 2016. The new Law includes improvements in several areas, including: (i) Responsibility for monitoring PEs is no longer diffuse and fragmented between many different line ministries but is concentrated in the Ministry of Economy. (ii) The mechanisms for monitoring and oversight of the PEs, in particular the corporatized ones, are being strengthened. More broadly, the PE Law is now much clearer on when the various corporate governance provisions from the PE Law apply, as opposed to applying the corporate governance provisions from the general Company Law. This is especially important since it reduces regulatory uncertainty, as in recent years many of the PEs moved towards corporatization, with the trend likely to continue. (iii) Improvements have been made with regards the accountability of General Managers, including more clarity on evaluation of their performance and criteria for the dismissal. Further, loopholes regarding the appointment of Acting Managers have been addressed. (iv) Some ambiguities (e.g. the process of short listing candidates; roles of different ministries and other institutions, etc.) in the public selection process for the General Managers have been streamlined. Also, criteria for selection of General Managers and Board Members have been further developed. We plan to further build on this in the coming years, including by developing mandatory training programs on corporate governance for the management of PEs.

Public Enterprises, for which the founder is the Republic of Serbia and which are subject to the Law on Public Enterprises, are obliged to have Audit Committee. Audit committees were established in the 20 Public Enterprises, while in 6 public enterprises forming is in progress. Restructuring and organizational changes are the main reasons for the delay in completing the process of forming the Audit Committee in certain Public Enterprises.

In parallel to improving the regulatory and corporate governance framework for all PEs, we have initiated comprehensive reorganization programs in the several largest utilities. These are supported by the World Bank (including through an upcoming Public Expenditure and Public Utility Development Policy Loan series) and by the EBRD. The reforms are focusing on the following companies:

- Elektroprivreda Srbije (EPS). In July 2015, a new organizational structure consisting of subsidiaries for electricity generation, distribution and supply, as specified in the corporate restructuring plan adopted in November 2014, became effective. In consultation with the World Bank and EBRD, we adopted the financial restructuring plan for EPS in early June 2015. Consistent with the five-year rightsizing target specified in the financial restructuring plan, the EPS supervisory board has adopted, in consultation with the World Bank, a credible 2016-19 optimization plan with no less than 1,000 net staff position reduction in 2016. Following the ongoing corporate restructuring process and financial consolidation, we will change the legal status of EPS to a joint stock company by July 1, 2017, with an aim to further enhance the corporate governance and viability of the company and ensure its professional management.
- Srbijagas. A new organizational structure consisting of subsidiaries for transmission and distribution became effective in August 2015. We initiated the preparation of a comprehensive restructuring plan, in consultation with the World Bank, with the objective of defining measures and reforms that would be necessary to achieve longer term financial viability and competitiveness of Srbijagas. We are preparing a debt restructuring plan to be adopted by end-October 2016, with a goal to (i) eliminate further debt-to-equity swaps; (ii) improve collections by imposing payment discipline; (iii) assess existing and proposed investment programs in consultation with the World Bank; and (iv) refinance existing liabilities based on audited financial information. We are also conducting a diagnostic of the gas distribution sector to address the fragmentation in the sector and identify options for how to achieve greater efficiency and economies of scale.
- Railways of Serbia. We established a Railway Reform Steering Committee, led by the Deputy Prime Minister and including senior representatives from relevant Ministries and entities, IFIs, and EU, to provide overall direction of the reforms. The unbundling of the company into separate passenger, freight, infrastructure, and a fourth company became effective from August 2015. We are implementing the financial restructuring plan which was adopted in October 2015 and developed in consultation with the World Bank, EBRD and EU. The Railways Reform Steering Committee adopted a conclusion in June 2016 which defines the rightsizing targets for 2016 (2,700 staff positions). In addition, based on proposals for network rationalization, we will consider closing about 800 km of unprofitable railway lines by end-2016. To support market competition, we have adopted all the necessary acts in order to allow network access to private operators in February 2016, and the first contract with a private operator was signed in June 2016.
- Roads of Serbia. We will revisit the adequacy of toll rates and on the expenditure side by adopting a plan for removing rigidities in pricing maintenance contracts in the second half of 2016 and implementing it for 1,000 km. The savings may result in lower budget support in the future. We will also explore concession options for the construction and maintenance

of Corridor XI. The corporate and financial restructuring plans for Roads of Serbia will be developed during 2016 in close consultation with the World Bank.

#### 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.

During 2015, out of RSD 16 billion available in the Transition Fund, RSD 11.08 billion were used to finance compensation packages for 19,791 redundant workers from the companies from PA portfolio. The same program is continued in 2016. As of August 24, 2016, out of RSD 6 billion available in the Transition Fund, RSD 2.31 billion were used to finance compensation packages for 3,737 redundant workers from the companies from PA portfolio.

Because the packages offered under the adopted 2015 decree (extended to apply in 2016) 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).<sup>1</sup> 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 for 2016, which outlines the annual provision of active labor market programs by the NES, has specific provisions for making ALMPs available to redundant workers (in the National Employment Action Plan for 2015, as well as for the 2016, redundant workers are defined as one of the categories of hard-to-employ unemployed persons and have a priority in ALMPs participation). Further, we are improving the outreach of NES to redundant workers to insure they are fully aware of the available options. In addition, during 2016 cooperation has been established with local employment councils (local self-government units) in the geographic areas where companies from the PA portfolio had redundant workers. Support to NES in the efforts to strengthen its capacity and improve services for the unemployed are being supported by the World Bank (including through Results-based Financing loan on Competitiveness and Jobs) and other partners, like the EU. As part of the project, and with regards the NES services aimed at unemployed persons, the aim is to improve methods and techniques of case workers professional counseling to unemployed persons, with continuous monitoring and evaluation of the implemented measures. In parallel, activities to improve the quality of services provided to employers, as well as to promote available ALMPs, will be implemented. As of August 2016, the TORs to provide support to NES in these reform areas have been published.

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<sup>1</sup> In the past, many redundant workers received packages in access to labor code provisions, which disqualified them from receiving unemployment benefits, but they had the possibility to register as unemployed and to participate in ALMPs offered by the NES.

We have adjusted the design of the 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, subsidy for self-employment, public works, re-training, job counseling, and job search assistance. Of these, public works is of particular importance because it gives to hard-to-employ categories, which have little to no chances of finding proper employment, the possibility to earn some income, at least for some months during the year. To the extent that redundant workers are defined as a hard-to-employ category – a well-designed public works program could fulfill this role of an additional safety net. Such an additional safety net is warranted, because the last-resort financial social assistance – although very well targeted – is rather narrowly defined, excluding many poor people. Hence, providing additional income opportunities for hard-to-employ categories of unemployed, as well as unemployed in the status of social need, at least for some months of the year, will strengthen the overall safety net, including for redundant workers from SOEs. In the past, the public works program raised concerns if it can fulfill its role of an additional safety net, but recent reforms have significantly improved the design. During May and June of 2015, the government re-designed the public works program to: (i) pay a contractual fee below minimum wage to participants; (ii) are limited to less-than-full-time tasks that support communal activities like, for example, elderly care, maintenance of public infrastructure, and preservation of nature; (iii) are giving priority to hard-to-employ categories of unemployed, as well as unemployed in the status of social need; and (iv) are limited in duration to six months of the year per person. In the medium term, the improved public works program can provide an important additional safety net for redundant SOE workers. During 2015, new concept of public works has been implemented, with 11,289 unemployed persons participating (including implementation through cooperation with local self-governments), which is 171.05 percent of the target coverage (6,600 persons). Public tender for organizing public works in 2016, in which unemployed and people with disabilities can participate, has been published by NES on February 17, 2016. During the first six months of 2016, 5,046 persons have participated in the programs (the target for the year is 6,900 unemployed persons). Participation in public works programs has been limited to four months.

We remain committed to reducing disincentives for formal sector work. In addition to fiscal costs linked to income tax and social security contribution evasion, informal employment is also a major concern as informally employed people are in a particularly difficult position. Informal workers suffer a significant net hourly wage penalty; they are also disadvantaged in terms of working conditions and job security. Trend analysis of informal employment suggests that their share in total employment is pro-cyclical. A negligible amount report having vacation and other benefits. All of this seems to have a significant impact on mental and physical wellbeing of the informally employed, and analysis indicates that informal employment is associated with significantly lower job, health and life satisfaction, even after accounting for income and labor supply.


Several steps are going to be undertaken in the aim to mitigate a social impact of the reform on especially vulnerable group of potentially generated new unemployment. We will task an inter-ministerial working group, established as part of the reforms supported by the Competitiveness and Jobs project and coordinated by the Public Policy Secretariat, to continue working on this important issue.

First, we will consider a reduction of tax wedge on low wages through removing disincentives for formal employment opportunities for low-paying formal jobs and self-employment, including considering options to reform the minimum social security contribution, but also taking into account the medium term macro fiscal framework. To this end we have performed a thorough analysis of the impact of the existing income tax and social security regime on the supply side of the labor market (see Annex to this letter). Yet the important demand side analysis is still forthcoming. Additional study aiming to develop policy options for improving incentives for formal employment of social assistance beneficiaries will be prepared during 2016 under the Competitiveness and Jobs project. The planned studies will build on the findings from the analysis undertaken so far and carry out the additional research outlined in the study prepared under this DPL. We plan to expand the scope of analysis under the study to also include further analysis of the minimum social security contribution. Developing sound policy options on how to reform minimum contributions will be of great value both to social assistance beneficiaries as well as to informal part time workers in Serbia in general.

Second, a comprehensive reform of the National employment service based on improved active labor market measures is going to be handled and supported by World Bank Competitiveness and Jobs project including better assessment and targeting with adequate active measures of vulnerable groups of hard to employ population.

Last but not the least, as envisaged by the Economic Reform Program adopted by the Government and presented to the European Commission under the European semester, we will improve adequacy of financial social assistance by linking the different sectors' information systems to ensure that clients have access to their social rights without administrative barriers and that the overall social assistance is better targeted. To this end, we will improve the existing legal framework; therefore, the Working Group on Amending the Law on Social Protection and the Working Group on Amending the Law on Financial Support to Families with Children have been formed.

Sincerely,



Dušan Vujović  
Minister of Finance

### ANNEX 3: FUND RELATIONS ANNEX

#### Press Release:

#### **IMF Executive Board Completes Fourth and Fifth Reviews of Serbia's Stand-By Arrangement**

Press Release No. 16/388, August 31, 2016

- Authorities indicated their intention to continue treating the arrangement as precautionary
- Serbia's economic recovery exceeded expectations
- Full implementation of program commitments is critical to strengthen the foundations for robust and inclusive growth

The Executive Board of the International Monetary Fund (IMF) on August 31, 2016 completed the combined fourth and fifth reviews of Serbia's economic performance under the Stand-By Arrangement (SBA). The completion of the review will make available the cumulative amount of SDR 608.01 million (about €761.6 million). The Serbian authorities have indicated their intention to continue treating the arrangement as precautionary.

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

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

"Serbia's economic recovery has exceeded expectations, supported by efforts to strengthen public finances, advance structural reforms, and boost investment confidence. However, vulnerabilities remain, including from elevated public debt and lingering structural challenges in an uncertain external environment. Full implementation of program commitments is critical to strengthen the foundations for robust and inclusive growth, restore public debt sustainability, and rebuild policy buffers.

"The fiscal over-performance has continued in 2016, supported by strong revenue and tight control of current expenditures. The challenge is to sustain the fiscal adjustment to place the high public debt firmly on a downward path. The completion of the first phase of public sector rightsizing will help contain the public sector wage bill in 2016, and further optimization will be guided by in-depth functional analysis. While the execution of capital expenditure has improved this year, measures are needed to strengthen the project appraisal process, enhance feasibility studies and risk analysis, and establish a single pipeline of public investment projects for the budget.

"The cautiously accommodative monetary policy stance is appropriate in view of strong fiscal consolidation and low inflation. The central bank's continued commitment to the inflation-targeting regime and exchange rate flexibility is welcome.

"Positive momentum in the financial sector reforms needs to be maintained by fully implementing the non-performing loans strategy. In addition, it is critical to implement the reform agenda of the state-owned financial institutions to reduce financial vulnerabilities and fiscal risks.

"Decisive implementation of the identified structural reforms is essential for reducing fiscal risks and supporting competitiveness and growth. While there has been good progress, full implementation of state-owned enterprise restructuring and resolution plans is needed to avoid further increase of fiscal risks and to achieve the program objectives.""

#### ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Environmental Effects	Poverty, Social or Distributional Effects
<b><i>Pillar A- Accelerating the restructuring and divestiture program for the Privatization Agency portfolio and selected SOEs operating in the commercial sector</i></b>		
<p><b>Prior Action # 1:</b> The Borrower has taken the following actions for at least ninety seven (97) PA Companies that were in the status of restructuring as of August 13, 2014: (a) through its Privatization Agency, Ministry of Economy, and Bankruptcy Supervision Agency: (i) established the privatization model and methods to be used for each PA Company to be privatized, and successfully privatized each such PA Company as evidenced by the finalized privatization contracts signed by the respective investors and the Borrower, or (ii) initiated formal bankruptcy proceedings with the relevant courts for those PA Companies that could not be privatized; (b) through the relevant PA Companies, prepared pre-packaged reorganization plans that have been accepted by the PA Companies' respective creditors and have been sanctioned by the relevant courts.</p>	<p>Overall, no significant adverse effects on the environment, forests and natural resources.</p> <p>Possible marginal positive effects resulting from: closing of companies with obsolete technologies; more environmental friendly technologies adopted through investments in successfully privatized companies; and reduction of accumulation of environmental liabilities.</p> <p>Significant Environmental risks identified related to past environmental liabilities.</p>	<p>Overall marginal positive indirect effects on poverty through expected impact of structural reform on economic growth and job creation.</p> <p>Significant adverse effects in the short run through job losses for workers in SOEs directly affected by the supported reform program.</p>
<p><b>Prior Action # 2:</b> The Borrower, through its Privatization Agency, issued Public Announcements for at least twenty (20) public bids for PA Companies that were not in restructuring as of August 13, 2014.</p>		
<p><b>Prior Action # 3:</b> The Borrower, through its Ministry of Agriculture and Environmental Protection: (a) selected a subset of the PA Companies, and companies in bankruptcy for which the PA was serving as the bankruptcy administrator, that were determined to present environmental risks; (b) assessed the potential environmental damages and the estimated volume of hazardous waste for this subset of companies; and (c) Initiated the disposal and treatment of the related hazardous waste.</p>	<p>Marginal positive effects, through specific measures to reduce stocks of hazardous waste.</p>	<p>Not significant.</p>

<b><i>Pillar B - Strengthening governance, regulatory and institutional framework, and monitoring and transparency arrangements for SOEs</i></b>		
<b>Prior Action # 4:</b> The Borrower adopted the Law on Public Enterprises to strengthen the regulatory framework for monitoring, and ensuring the accountability and transparency, of Public Enterprises, including for corporatized enterprises that are subject to the Law on Public Enterprise.	Not significant.	Not significant.
<b>Prior Action # 5:</b> The Borrower, through the decisions of the supervisory boards of the respective Public Enterprises, established audit committees in at least twenty (20) Public Enterprises that are subject to the Law on Public Enterprises and of which the founder is the Republic of Serbia.	Not significant.	Not significant.
<b><i>Pillar C- Mitigating the social and labor impact of the SOEs reform program</i></b>		
<b>Prior Action # 6:</b> The Borrower, through its Ministry of Labor, Employment, Veteran, and Social Affairs and its National Employment Service (“NES”) improved the design and targeting of the Public Works program by: (a) prioritizing applications from persons who are deemed redundant, unskilled, or hard-to-employ; (b) restricting the scope of public works to social and humanitarian activities and to the maintenance and refurbishment of public infrastructure and preservation of the environment; and (c) limiting the payment of remuneration to RSD 15,000 per person per month under a casual employment contract.	Not significant.	Significant positive effect on workers directly affected through direct mitigation measures supported.