EXECUTIVE SUMMARY

Since restarting its transition to a market economy in late-2000, Serbia has made good initial progress across a range of areas. This progress began from a very difficult starting point which reflected the legacy of a decade of isolation, conflict, and poor economic management. Strong stabilization efforts coupled with greatly increased capital inflows (from new donor support, remittances, foreign direct investment, and remonetization) have supported a reduction of annual inflation from over 100 percent in 2000 to below 10 percent in 2003. Ratios of debt to GDP have declined while foreign exchange reserves have increased substantially. Initial reforms of the trade regime, ownership relations, the business environment, the financial sector, the labor market, and the education system, have also begun to lay the foundations for more rapid growth. As a result, Serbia’s previously dysfunctional banks are beginning to attract new deposits and make new loans. Economic activity is being shifted to the private sector. Building on these changes, Serbia’s real GDP grew by an average of 4.2 percent per year from 2001 to 2003, with average consumption growing at an even faster pace.

However, deep structural weaknesses remain. Growth rates of around 4 percent per year will not suffice to produce a rapid convergence of living standards towards historical levels and levels in the more successful reforming countries of Central and Eastern Europe. As in many economies in transition, the initial output recovery has yet to bring an increase in employment. A significant share of Serbia’s production and employment remains in the informal sector. Key determinants of growth potential such as exports, investment and domestic savings remain extremely low. Still significant albeit reduced macroeconomic imbalances and debt burdens continue to render the economy vulnerable to shocks. Despite a growing private sector and much improved market access, Serbia’s foreign trade remains largely unrestructured, with little reorientation towards the European Union and a largely unchanged commodity composition.

Moreover, the positive elements of Serbia’s recent performance are not sustainable without further adjustment and sustained reform. This is for both macroeconomic and structural reasons. Supported by the sharp increase in capital inflows and by debt restructuring, Serbia’s recent growth was driven by domestic demand. This cushioned the initial impact of reform and helped jump-start investments, but also led to large current account and fiscal deficits, which are unsustainable in the medium-term. Fresh capital inflows are likely to decline and have a lower grant element, while debt service payments will rise as grace periods expire and new debt begins to be repaid. The resulting need to achieve substantial and rapid declines in current account and fiscal deficits will require Serbia to shift to an entirely different type of growth which is led by exports, rather than by domestic demand. The macroeconomic policies which have been successful to date will need to be revised in the face of these new challenges.
Initial rapid structural reforms have slowed and remain incomplete. A major burst of reforms during 2001 and the first half of 2002 was followed by much slower and less coherent performance, with good progress in some areas tempered by actual or threatened backtracking in others. Political instability has been a major factor hampering reform efforts. Cumulative reforms need to reach a certain critical mass before bringing a robust supply response. Serbia needs to do far more before it can reach that point. Despite the noted initial achievements, measures of cumulative reform progress such as the EBRD Transition Indicators still show Serbia and Montenegro near the bottom of the group of transition economies. Furthermore, Serbia is still at a very early stage in integrating its economy with European structures, an objective which will increasingly drive its future agenda of reform and institutional strengthening. Thus, there is an urgent need to push ahead with reforms across a range of areas.

This report analyzes Serbia’s recent performance and near-term reform priorities in five areas which are particularly important for growth and employment creation. Macroeconomic policy, international trade and regional integration, private and financial sector development, the labor market, and education/training, are all crucial for increasing investment, sustaining employment, and improving productivity. They are also important for achieving two other important overarching objectives; (i) moving informal activity to the formal sector; and (ii) gradually integrating Serbia’s economy with European structures.

While reforms need to implemented across the board, some will have more rapid payoffs than others. Given Serbia’s low savings rate and its need to reduce the current account deficit, near-term growth is unlikely to come from major increases in investment rates. As recorded employment rates are already high, near-term growth will also probably not be driven by further increases in employment (which is likely to fall before beginning to rebound). For these reasons, the immediate growth impulse will need to come from improved external competitiveness (through adjustments in macroeconomic policy) and enhanced productivity. The greatest potential for rapid increases in productivity lies in reallocating Serbia’s existing resources of land, labor and capital to higher productivity uses. Labor market reforms will be needed to keep the fall in employment to a minimum and to ensure a smooth movement of workers to new jobs. In the medium-term, higher productivity will increasingly come from new investments. Reforms of Serbia’s education sector will have a much longer-term impact but need to be implemented now.

The following eight themes emerge as the key reform priorities for enhancing growth and employment generation in Serbia.

1. Enhanced political stability and improved governance are key prerequisites for sustained growth. A high level of perceived risk is the single greatest deterrent to both domestic and foreign investment. Surveys of incumbent businesses in Serbia cite policy uncertainty as the single greatest weakness in the business enabling environment. Serbia will only be able to benefit from the technical improvements discussed below if political stability is greatly enhanced, if the risk of sudden shifts or major reversals of policies is eliminated, if perceptions of corruption are reduced, and if the overall quality of governance is further improved.
2. **The size of the public sector needs to be reduced.** Serbia has made good progress in reducing hidden fiscal burdens, particularly budgetary arrears and losses in the energy sector. However, consolidated public spending has steadily increased to a very high around 47 percent of GDP, very little of which goes to the public investments which is crucial for growth. The resulting high tax burden and budget deficits crowd out private activity or push it into informal channels, while also raising macroeconomic vulnerability. Against this backdrop, the creation of a growth-enhancing public sector will entail focusing on the following policy priorities:

- **Non-interest current spending as a share of GDP needs to be reduced in a significant and sustained fashion.** This is required to reduce overall spending while allowing some increase in public investments. The greatest scope for savings is in the following categories of spending – the public sector wage bill, the health sector, public pensions, and subsidies. The rebalanced budget for 2004 and the draft budget for 2005 represent important first steps in this direction, and this progress needs to be consolidated through further such adjustments in later years. Such expenditure adjustments will only become sustainable if they are supported by reforms which directly and permanently address the underlying expenditure commitments and entitlements, and which improve the functioning of Serbia’s public administration and overall public sector.

- **The savings from expenditure containment need to be channeled primarily into deficit reduction.** Given its large public debt and need to reduce the current account deficit, Serbia has no scope to ‘stimulate’ economic activity through fiscal policy. Public revenues need to be secured until the underlying expenditure adjustments have been achieved. Any further gradual reductions in tax rates will need to be paired with efforts to broaden the tax base and further improve the effectiveness of tax administration. A continued prudent shift from direct towards indirect taxation could also promote the needed increase in national savings.

3. **The strong anti-export bias in the Serbian economy needs to be addressed.** Serbia’s large current account deficit reflects very low exports rather than high imports. Starting from such a low base, Serbia has great potential to expand its exports under the right set of policies and institutions. To date, it has been unable to exploit this potential, despite greatly improved formal access to its main markets. Addressing the anti-export bias behind this poor performance requires changes in four broad areas:

- **Past reductions in tariffs need to be deepened, and the institutional framework for trade policy strengthened.** Such adjustments could take place in the context of negotiations on WTO accession and the EU Stabilization and Association process. As the current account deficit is an indication of macroeconomic imbalance, it should not be addressed through increased protection. This would also reduce the benefits of enhanced competition on productivity, and drive away investors who wish to locate in Serbia to serve a large integrated market. Further reforms should focus on reducing tariffs on finished products in sectors where tariffs are escalated and on eliminating remaining non tariff barriers. Greater clarity in the institutional framework for the
formulation and implementation of foreign trade policy is also necessary to reduce costs and avoid distortions in trade transactions within SaM.

- **Regional and global trade integration needs to be accelerated while ensuring close coordination among its various dimensions.** EU integration in the context of the Stabilization and Association process and liberalization with neighboring states in South East Europe should go hand in hand in order to avoid potential trade distortions. This needs to be accompanied by stepped up efforts to accede to the World Trade Organization in order to guarantee security over Most Favored Nation market access, reduce potential distortions arising from regional trading arrangements, and modernize the regulatory and legislative framework governing trade and investment.

- **Institutions which help Serbian firms’ access external markets need to be strengthened.** Their poor functioning is one of the main reasons why Serbia has yet to take advantage of the very extensive formal market access it has already achieved. Priority reforms include the modernization of standards and technical regulations to achieve compatibility with EU and international standards, and the further strengthening of customs and other border agencies.

- **The mix of macroeconomic policies needs to be adjusted.** Serbia’s recent combination of somewhat loose fiscal policy and tight monetary policy has increased domestic demand and contributed to a real appreciation of the dinar. This has fueled imports while reducing the incentives and opportunities to export. To achieve export led growth, Serbia must place a greater share of the burden of stabilization of fiscal policy (the draft 2005 budget is a welcome step in this direction), taking the pressure off of monetary policy. The resulting lower domestic demand and a more competitive real exchange rate would simultaneously discourage imports and encourage exports.

4. **The privatization of enterprises and banks needs to be completed.** A large and strong private sector, supported by an efficient financial sector, is crucial for growth. The report shows that new private and privatized firms in Serbia clearly outperform SOEs. Firms in pre-privatization limbo face little incentive to search for new markets, restructure their production, or create new and more secure jobs. At the same time, Serbia’s inefficient and problem-laden state-owned banks cannot provide intermediation to real sector on a sustainable and affordable basis. While Serbia has laid a solid foundation for the divestiture of enterprises and banks, the initial momentum has not been sustained. Two key priorities stand out in the area of ownership reform:

- **Privatization needs to be reinvigorated, with a continued focus on sales to strategic investors.** On the enterprise side, the tender and auction privatization of SOEs in the Privatization Agency (PA) pipeline needs to be accelerated without a fundamental change in the privatization model. The restructuring and subsequent sale of troubled industrial conglomerates also needs to be speeded. In parallel, Serbia needs to achieve the accelerated transparent privatization of viable state-owned banks to strategic investors through open tenders, especially as further delays may lead to the deterioration of the condition of banks, and to liquidate or merge those banks which...
cannot be sold and/or are unlikely to compete effectively even if their balance sheets could be cleaned up.

- **Property rights need to be protected.** To continue attracting FDI and local investment, the government must ensure a consistent treatment of the first group of investors which bought companies in tenders. Unless clear illegal transactions have been proven, the reversal of privatization transactions would introduce uncertainty and be detrimental to future transactions.

5. **Financial discipline needs to be enhanced, including through greater competition.** This is crucial for encouraging enterprises to actively search for new markets, for enhancing efficiency, and for ensuring that poorly performing firms release factors of production to higher productivity uses. By encouraging firms to maintain wage increases in line with productivity growth, it will also promote employment, investment (by increasing retained earnings) and export competitiveness. In addition to the further enhancement of import competition described above, the key reforms for achieving the noted objectives fall into three groups:

- **Improvements in the bankruptcy system need to be effectively implemented.** Building on the recent enactment of the important law on bankruptcy, priority reforms include: building institutions required to implement the law; raising the resources and training the personnel required to build the Supervisory Agency and the unit which will administer the socially owned companies; and initiation of bankruptcy proceedings by the state in its role as creditor through the tax administration, the electric power company (EPS), and state-owned banks.

- **The reform of large utilities needs to be expanded and deepened** through: continuation of the unbundling and restructuring (workforce and debts) of public utilities; resolution of the debts of companies under the restructuring program of the PA which have the largest debts to EPS by restructuring and offer for sale of the debtor companies; establishment of an adequate regulatory framework in the relevant sectors prior to privatization; and resolution of the legal problems created by the fact that both the capital and physical assets belong to the state, prior to restructuring or privatization.

- **The regulatory and supervisory regime for the banking system needs to be strengthened** through: enhancement of National Bank of Serbia (NBS) supervisory capacity by timely implementation of the Supervisory Development Plan; maintaining proper fiduciary oversight of state-owned banks through coordinated efforts of the Bank Rehabilitation Agency, NBS and Ministry of Finance in the period leading to resolution; conducting on-site examinations at the fastest growing private banks, with appropriate remedial action as may be necessary; and improving the legal and institutional framework for bank exit.

6. **The business enabling environment needs to be further improved.** Ownership transformation and enhanced discipline will not be enough to secure growth. This also requires the smooth movement of the factors of production from low to high productivity enterprises, and
the ability of these firms (including foreign owned firms) to then expand their production. The access of Serbian firms to export markets described above is one crucial element of the business environment, especially from the perspective of foreign investors. Other key priorities identified in the report fall in four areas:

- **Contract enforcement needs to be strengthened** through: simplifying enforcement procedures by effectively implementing the recently adopted Law on Execution Procedure; strengthening the performance of bailiffs by adopting the relevant by-laws and training; and strengthening court resources through education, improved court statistics and information sharing.

- **Access to credit needs to be enhanced** through; continuing the establishment of publicly accessible leasing and pledge registries; adopting a new Mortgage law; focusing on the provision of public goods (contract/collateral enforcement) rather than direct state support; and auditing the performance of state-owned credit-granting institutions such as the Development Fund.

- **The regulatory burden on enterprises needs to be reduced**, including through: introduction of the public discussion on the draft laws as a rule and not as an exception; requirement of a justification statement for all laws and other regulations that explains the expected benefits and costs of the actions; and identification and removal of overlapping functions of various state authorities.

- **Access to land needs to be improved** through: changing the constitutional treatment of urban land; removing various administrative barriers to access to land; resolving the issue of restitution; implementing a phased decrease and enhanced enforcement of the property transfer tax, with compensating increases in other taxes; and enhancing the human and physical resources in various components of the land management system, such as cadastre.

7. **The flexibility of the formal labor market needs to be further enhanced.** Despite greatly improved laws on labor and employment, the formal labor market remains rigid and continues to function poorly, while employment continues to move to the much more flexible informal labor market. Such barriers discourage new employment while hindering the movement of workers key to better and more secure employment. Youth, women and the less well educated are at a particular disadvantage in the formal labor market. Finally, wage discipline appears to be poor, with recorded real wage growth greatly exceeding productivity growth. Priority reforms of labor markets fall in three broad areas:

- **The removal of legal/administrative and institutional barriers to the functioning of the formal labor market needs to be sustained.** Areas for improvement include: further limitation of minimum severance payments; expanding the scope for part-time, short-term and seasonal employment; improving the functioning of social dialogue through stronger and more credible representation of employers; and ensuring that minimum wages do not reach levels which will adversely affect employment prospects, particularly of youth and the least skilled.
• **The growth of real wages needs to be kept in line with productivity growth.** This is crucial for sustaining the demand for labor and thus supporting higher employment rates. This requires enhanced financial discipline on enterprises, a stronger role of employers in collective bargaining, and the continued imposition of direct limitations on wage growth in the budgetary and SOE sectors.

• **Programs of financial and active support for job losers need to be restructured and reoriented.** The scaling back of the costly Social Program could free resources to adequately fund Serbia’s well-designed unemployment benefits, and finance a more targeted set of active labor market programs selected based on transition experience, and in line with available administrative resources of the Labor Market Bureau.

8. **Serbia’s education and training system needs to be re-oriented.** The poor quality of and low enrollment rate in secondary education are major barriers to growth. Low secondary enrollment hampers the improvement of Serbia’s already relatively low average levels of educational attainment. Poor quality is reflected in the inability of the system to provide the skills required to succeed in today’s labor market, especially a high share of students in vocational streams. The tertiary education system is inefficient, including a very long average period before a student graduates and the fragmented structure of universities. Finally, limited adult education and training opportunities make it difficult for those with inappropriate skills to overcome these shortcomings. Priority reforms in education and training fall into three groups:

• **The serious problems of quality and enrollment in secondary education need to be addressed.** Most urgently, the number of students completing a four-year secondary education needs to be increased through a shift away from vocational education programs, particularly those of only three-years duration. This would provide people with the broad and flexible skills demanded in a dynamic market economy, reduce unit costs, and provide resources for investments in quality. Secondary education also requires improved measures of education quality.

• **The efficiency of tertiary education needs to be enhanced.** Priorities include reforming the governance of universities towards European-style corporate institutions, and enhancing the incentives for universities to help students graduate on time with the knowledge they need.

• **Opportunities for adult training need to be expanded,** particularly in SMEs. This requires encouraging foreign investors (which tend to provide higher levels of training) and establishing a certification and quality control framework for adult education and lifelong learning.

Many of the described reforms will also help Serbia to meet the important challenge of reintegrating informal activity into the official economy. A large informal sector hampers growth by undermining productivity and preventing more productive formal companies from gaining market share. Key reform measures for reducing informality include: gradually reducing
taxes on labor while sustaining overall revenue performance by shifting towards indirect taxation, broadening the tax base and improving tax collection and enforcement; reducing smuggling through trade liberalization; implementing the described improvements to the business enabling environment; and enhancing the flexibility of the formal labor market.

As demonstrated in greater detail in the report, the outlined package of substantial and permanent fiscal adjustment and sustained progress in structural reform could generate the higher investment rates and more competitive economy which can produce rapid and sustainable growth of living standards over the medium-term. Such policies, need to be implemented with urgency and unwavering commitment. Given Serbia’s tightening macroeconomic constraints and incomplete reform agenda, a muddling-through approach to fiscal adjustment and reform would seriously undermine Serbia’s ability to improve living standards. In fact, an attempt to avoid the necessary adjustments could well place Serbia on a path to slowing and even negative rates of consumption growth, and leave its economy unacceptably vulnerable to external and internal shocks.