

# SERBIA AND MONTENEGRO

## Recent Progress on Structural Reforms

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This report has been prepared by the Europe and Central Asia Region of the World Bank for the Donor Co-ordination Meeting for Serbia and Montenegro, to be held in Brussels on November 18, 2003. It was prepared based on information and comments provided by Bank staff, government officials in Serbia and Montenegro, multilateral agencies, bilateral donors, and NGOs. The report reflects the views of World Bank staff. It is designed as a selective overview of progress in structural reforms, rather than as a systematic or comprehensive review of progress in all areas which have received donor support, or as a detailed sector-by-sector evaluation of relative progress in the two republics. For this reason, it does not cover macroeconomic and fiscal policy, humanitarian assistance, or areas which, while important and/or supported by donors, are not directly associated with structural reforms

## Serbia and Montenegro

### Recent Progress on Structural Reforms

#### Introduction

1. The transition of Serbia and Montenegro<sup>1</sup> to democracy and a market economy began under very difficult economic and social conditions. These conditions were the result of more than five decades of inefficient economic management and a decade of regional conflicts and international isolation that followed the break-up of Socialist Federal Republic of Yugoslavia in 1991. By 2000, recorded per capita GDP was less than half of its 1989 level, external debt exceeded 130 percent of GDP, and annual inflation was over 113 percent. The authorities began to stabilize and transform the economy by tightening macro-economic policies and recommencing market-oriented structural reforms, combining their own efforts and with the strong support of the international community. In general, the reform process started earlier in Montenegro, while political events in Serbia prevented substantial reform before early 2001 when the newly elected republican government took office.

2. The renewed transition of Serbia and Montenegro to a market economy is based on a government strategy with four main pillars:

- restoring macroeconomic stability and external balance;
- stimulating near-term growth and creating the basis for a sustainable supply response;
- improving the social well-being of the most vulnerable and building human capacity; and
- improving governance and building effective institutions.

3. The strategy was presented to a Donor Conference in June 2001, and summarized by the World Bank and European Commission in the medium-term Economic Recovery and Transition Program (ERTP).<sup>2</sup> The assembled financial institutions and donors together pledged financial resources of around \$1.3 billion to support the first phase of the program. Subsequently, additional support has come through new commitments of similar annual magnitudes and from debt rescheduling through the Paris Club, while negotiations continue with the London Club. One of the overall goals of the ERTP was to facilitate increasing integration with the European Union (EU) and the World Trade Organization (WTO).

4. The donors will reassemble in Brussels in November, 2003, to assess progress made on implementing the agenda, and to discuss future reform and assistance priorities. The purpose of this paper is to review performance under the ERTP during the past two and one-half years, in

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<sup>1</sup> The Federal Republic of Yugoslavia completed its constitutional transition to Serbia and Montenegro in February 2003. In this report, the treatment of Serbia excludes the province of Kosovo, which is under U.N. administration according to UN Security Council Resolution UNSC-1244.

<sup>2</sup> World Bank/European Commission, *Breaking with the Past: The Path to Stability and Growth*, (Wash. DC, 2001), and Government of Serbia, *The Reform Agenda of the Republic of Serbia: The Needs for International Financial Assistance*, (Ministry of International Economic Relations, Belgrade, 2003), and Government of Montenegro, *Economic Reform and Recovery Strategy* (National Aid Coordination Unit, Podgorica, 2001).

terms of structural reform progress, problems encountered, and priorities for the future.<sup>3</sup> The key areas treated are grouped into four main areas, as follows:

**Private Sector Incentive Framework**

- Trade liberalization and customs reform
- Business environment
- Labor law reform

**Productive/ Financial/ Infrastructure Sectors**

- Financial sector
- Agriculture
- Energy
- Transport
- Telecommunications
- Environment, water and waste management

**Public Sector**

- Governance and public sector reform
- Privatization/public enterprise reform
- Judicial reform

**Social Sectors**

- Education
- Health
- Pension reform
- Social and child protection

**Overview**

5. Substantial progress has been made in almost all areas of the ERTF, although some have advanced further than others. As republican parliaments and governments retain most of the legislative and executive power, reforms have proceeded at different paces in each of the two republics. In Serbia, very impressive progress during the first roughly one and one half years of reform gave way to a period of slower but still broadly sound progress. The renewed commitment to reform and cooperation following the tragic assassination of the Serbian Prime Minister in March 2003 was short-lived, and the early summer saw a reemergence of politicking. While Montenegro's ruling coalition garnered a strong majority in the 2002 elections, political divisions and concerns of various stakeholders combined to work against an awaited major acceleration of structural reforms. In both republics, the need to agree on a new constitutional framework for the country required significant attention by government officials, also distracting attention from the reform effort. The relative cumulative progress in economic reform varies sectorally across the two republics, with Serbia more advanced in some areas and Montenegro in others.

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<sup>3</sup> A separate presentation by staff of the International Monetary Fund, will review recent macroeconomic developments.

## I. Private Sector Incentive Framework

### Trade Liberalization and Customs Reform

6. Trade in general, and particularly the foreign trade regime, was under tight control of the previous political and economic elite during the 1990s. This was partly the heritage of policies from the Communist era and partly the desire of empowered groups to maintain special benefits. As a result, the trade regime was non-transparent, highly protectionist (including non-tariff barriers) and overly regulated.

7. In *FRY/Serbia*, initial deregulation of foreign trade began in December 2000, when the then Federal Government cut various administrative barriers. Tariff reform began in 2001 with the passage of a greatly improved Customs Tariff Law. Average tariffs (unweighted) dropped from 14 to 9.4 percent, and the tariffs simplified from 37 to six rates, ranging from 1 to 30 percent. A large number of quotas and licensing requirements was also abolished. However, export controls continue on certain agricultural products, and import licenses continue on certain steel products. Any resurgence of protectionist sentiment is inconsistent with the further liberalization required to enhance competition and create the foundations for export-led growth. In *Montenegro*, tariff reform began earlier, in 1999, and was more extensive. Tariff rates were set in a range of 0 to 15 percent, with an unweighted average of 3.4 percent. The existence of two tariff regimes, however, presents many problems within the State and is a barrier to deepening SAM's relations with the WTO and EU, and also with the other countries of the region with which SAM intends to conclude free trade agreements.

8. An Internal Market and Trade Action Plan to harmonize trade, customs and excise regimes between the two republics and to create the single market envisaged by its Constitutional Charter was approved in August 2003. The result is an initial harmonization for 93 percent of products at a rate somewhat between the relatively low rates of Montenegro, and the higher rates of Serbia, with some exceptions such as iron and steel products. A further group of tariffs will be harmonized over a period of 18 to 24 months, achieving an average unweighted tariff rate of about 7 percent. However, the schedule for the reduction of tariffs on 56 strategic (agricultural) goods has yet to be defined and special import charges and levies remain at the republican level. Other liberalization measures in the past year include the phasing out of non-tariff barriers on exports, with those on imports to be eliminated by end-2004 (except for steel products and certain illegal goods). SaM is an active participant in the Stability Pact initiative to establish free trade agreements with other Pact countries. Autonomous trade measures (ATMs) have been unilaterally granted by the EU, permitting SaM unlimited duty free access to the EU market (with some minor exceptions, such as wine, baby beef, fish and textiles). Further work is needed in the areas of customs administration, and especially in the coordination of phyto-sanitary controls and certification of origin.

### Business Environment

9. The pre-reform private sector environment in SAM was not business-friendly owing to a variety of factors, including: the collapse of rule of law; lack of regulatory legislation in many fields; lack of access to credit due to the poor state of the banking sector; non-transparent tax

systems with a high level of corruption in state administration; loss of foreign markets due to international sanctions; and the poor state of physical infrastructure.

10. Over the past two years, the governments of both Serbia and Montenegro have made progress in business-enabling reforms, including liberalization and deregulation of foreign trade and investment, simplification of the tax regime, and modernization of labor legislation. However, despite such progress, significantly higher domestic private investments have yet to be realized. The recent sharp increase in foreign direct investment has primarily come through privatizations in a few attractive sectors, with the high sales prices of some major firms partly reflecting the artificial erection of tariff and other barriers to competition.

11. **Serbia.** The Government of Serbia set an ambitious reform agenda aiming to: improve the regulatory framework for business entry; facilitate the efficient operation of business through modification of the Enterprise Law; improve enterprises' access to finance; and reduce barriers to the efficient exit and redeployment of non-productive assets. The Government launched a comprehensive reform of business registration at the end of 2002, and plans to complete the process by the second quarter of 2004. These laws would create a unified Serbian business registry that includes all business activities covered under the current Enterprise Law and Law on Private Entrepreneurs. Considerable progress has already been made in achieving the objective of reducing the number of days and costs to register an enterprise.

12. The authorities have adopted a number of key laws and regulations aimed at creating a legal and institutional framework to support credit transactions and easier access to finance. The Law on Secured Financing initiated a framework that will be completed with the introduction of the new pledge registry. The adoption of the new Law on Financial Leasing contributed to the establishment of a leasing sector that is enabling easier access to capital. A new Law on Concessions replaced the auctions approach with a more transparent tendering mechanism for awarding concessions, and is expected to facilitate privatizations through BOT (Build, Operate, Transfer) schemes and similar arrangements.

13. The Government has drafted a new Bankruptcy Law. This very important act is designed to create financial discipline that will encourage and facilitate the exit of unviable enterprises, as well as the restructuring of potentially viable firms (through US Chapter 11-style reorganizations). The Law envisages the establishment of the Bankruptcy Administration Agency, and includes provisions to expedite bankruptcy proceedings and improve creditor rights. The rapid adoption and effective implementation of this long delayed law, which awaits parliamentary action, will be critical for hardening enterprise budget constraints and for reallocating resources to the most effective uses.

14. The rapid progress in privatization and new private business development has exposed significant legal weaknesses, particularly in the area of corporate governance. The Government has prepared the draft law on Economic Entities (Enterprises) that aims to address these weaknesses, and provide for more flexible and effective legal forms for enterprises. This law is expected to be considered by the Parliament in 2004.

15. Serbia has over 200,000 registered SMEs, including sole proprietorships. A new Small and Medium Enterprise Agency established in 2001 has since formed ten regional SME agencies. The agency provides technical assistance and training to SME entrepreneurs, and helps facilitate access to commercial credit. A new strategy on SME development was adopted in 2003, and the SME Agency has also been involved in the drafting of laws on business environment, especially the Law on Private Entrepreneurs.

16. *Montenegro.* A similar program of improvements to the business climate has been undertaken in Montenegro. These include new business registration procedures which have significantly reduced the time for a basic start-up, and a new Bankruptcy Law that aims to make the process faster and more efficient, and permits the use of licensed trustees from the private sector. A Law on the Private Sector Participation in Delivery of Public Services sets the stage for the use of concessions, such as BOT and other devices to permit greater private sector involvement. The remaining capital controls on foreign transactions are expected to be phased out this year. In general, Montenegro is more advanced in completing the legal framework for private sector development, but may face greater challenges in developing the institutional capacity needed to ensure their effective implementation.

### **Labor Law Reform**

17. Both Republics inherited a system of labor laws that provided generous and unsustainable social protection both to workers and the unemployed, at the price of raising labor costs and discouraging labor mobility. At the same time, an inefficient system of labor bureaus focused mainly on providing free social services to the unemployed rather than on pro-active employment programs, such as retraining and education. High wage taxes and levies (70-100% of net wages) and benefits dictated through national and sectoral collective bargaining agreements, discouraged formal sector employment. As a result, a large gray economy developed of workers who are outside of the formal system and do not contribute to social security or other taxes, which in turn leaves these workers with little real protection and reduces government revenues from these sources. For the future, there is a need to ensure that rigidities removed from labor laws are not simply replicated elsewhere, for example in collective bargaining agreements.

18. *Serbia.* A revised labor law passed in December, 2001 creates the scope for enhanced labor mobility and job creation by simplifying the process of hiring and terminating employees, and by reducing labor costs. The law establishes basic employment criteria (age limits, working ability, prohibition of discrimination). Minimum levels of severance payments have been lowered from levels which were the highest in the world, and firing procedures have been simplified. Minimum wages can now be set independently by the Government, and can vary across job categories. Other wages are subject to collective bargaining agreements, including an overall national agreement. A new Law on Employment (July 2003) provides a basis for the reform of the existing Labor Market Bureau and allows for the establishment of private employment agencies. The law aims to foster a more pro-active employment policy by strengthening linkages between labor supply and demand. Recent reductions in the real level and duration of unemployment benefits, along with improved controls over payments, will improve the financial sustainability of the system and enhance incentives for seeking new

employment. Nonetheless, benefits remain high by regional standards, and further reforms are required.

19. **Montenegro.** Labor legislation in Montenegro was reformed in 2003 with the long delayed enactment of a new labor law that reduced minimum required severance payments, paid maternity and other leave. Severance payments on job termination are set at 6 months of salary in the new law, down from an exceedingly high 24 months under the previous law. While the new law represents a major step forward, further amendments will be required to address remaining rigidities. Most specifically, labor markets continue to be regulated by a complex three-level set of collective agreements; a general agreement at the national level, as well as sector and specific company-level agreements. Minimum wages are set under these agreements for each job based on a negotiation between employer and unions. Also, many collective agreements call for severance payments and other benefits that are more generous than those specified in the law. The general agreement requires that workers laid off because of adverse economic conditions, etc. are entitled to continue to receive 50 percent of their salaries. Again, the challenge is to ensure that rigidities removed from the labor law are not simply recreated at the level of such agreements.

20. High wage taxes remain a major deterrent to new job creation by the private sector. Wage taxes and contributions average about 94 percent for middle-level jobs (defined to be ones paying E250 per month), and even higher for higher paying jobs. These taxes/collections include social security, income tax, unemployment fund, development fund and health levies, as well as some taxes introduced by local communities. The Government has instituted a temporary one-year reduced rate of 20 percent for jobs legalized this year. The result was a growth of registered employment of over 20,000 “new” jobs, and a 30 percent drop in registered unemployment. However, many of these jobs appear to be brought on to the books from the gray economy, and could again disappear into the shadow economy once subject to normal levels of taxation.

## **II. Productive/Financial/Infrastructure Sectors**

### **Financial Sector**

21. The financial sector in both republics was in a very poor state for a long time prior to 2000. During the 1990s, there was no notable activity in credit markets and mobilization of resources for new investments was negligible. Much of the system, and particularly the largest banks, suffered from a chronic lack of liquidity. Public confidence in the sector was almost entirely lost due to recurrent shocks (freezing of private foreign currency savings, pyramid schemes, hyperinflation, etc).

22. Both republics have made concerted efforts to restore the viability of the banking sector, improve supervision, privatize publicly-owned institutions and attract foreign banks to enter the market. Initial work has also begun on areas in the non-bank financial sector, including modernization of the stock exchange, and improved regulation of insurance companies. Despite this initial progress, interest rates remain high and are a major deterrent to new investment.

23. **Serbia.** Under the leadership of the National Bank of Serbia (NBS), 25 insolvent banks representing nearly two-thirds of the assets of the banking system have been liquidated or put under bankruptcy. The bold measures to place the four largest state-owned banks into bankruptcy in early 2002 played a crucial role in restoring public confidence in the banking sector, which has led to a quite visible rebound in bank intermediation. A Bank Rehabilitation Agency (BRA) has been given authority to administer banks in bankruptcy. Seven new banking licenses have been issued (mainly to foreign banks), reflecting growing confidence in the Serbian banking system. In July, 2002, the Government initiated a debt-for-equity swap to resolve debts owed to the Paris and London Club financiers. This process, which remains incomplete, resulted in a *de facto* nationalization of a large part of the banking system, with the state currently holding controlling equity stakes in eight banks (including two of the three largest banks) and a significant stake in eight other banks (including the largest private bank in the country). These stakes will be offered for sale during 2004 – 2005, with tender procedures for the first three or four banks planned for first half of 2004. The closure of the ZOP (Accounting and Payment Operations Office) in early 2003 ended the government's monopoly on inter-bank settlements, and has helped foster financial sector growth. In 2003, Serbia joined the Egmont Group of Financial Intelligence Units which work to combat money laundering.

24. **Montenegro.** The largest bank, Montenegrobanka, was sold in July 2003 after many assets and liabilities related to sovereign lending had been lifted out. The privatization of Podgoricka Banka, the last bank with a direct majority ownership of the state, is underway. The offshore banks that had been registered in Montenegro, but produced little if any benefit to the legal economy in that republic, have now had their licenses revoked by the Ministry of Finance. All correspondent banking relationships with licensed banks have been terminated, and offices of these banks in Montenegro are under investigation. A Law on Anti-Money Laundering was also adopted in 2003. A recent Basel II Core Principles Assessment gave a positive assessment of banking supervision in Montenegro, with the Central Bank now moving to address those issues where compliance was not strong. With the closure of private Ekos bank in 2003, the liquidation of Jugobanka, and the assets lift and subsequent sale of Montenegrobanka, the central bank considers all banks to be liquid and in compliance with capital requirements. The transparent privatization of Podgoricka Banka and the creation of a viable mechanism for recovering the maximum amount from carved out assets and liabilities of restructured banks represent important near-term benchmarks in banking reform. A deposit insurance scheme is expected to be initiated in mid-2004, but capital is needed to finance the insurance fund. A new Insurance Law has also been drafted.

## **Agriculture**

25. Agriculture is an important sector for both republics in terms of export, production and potential for poverty reduction. Agriculture is estimated to represent over 20 percent of Serbia's GDP, and about 15 percent of Montenegro's GDP. Like other sectors, it has suffered from poor state policies, serious mismanagement (particularly within large state agro-enterprises), disinvestments and infrastructure destruction, and losses of international markets. In an attempt to prevent social unrest, past governments firmly controlled prices of food and agricultural products at low levels, discouraging production and investment in the sector, and leading to food

shortages. The rural sector continues to have high levels of poverty and low productivity and needs to be a focus in future poverty reduction plans.

26. **Serbia.** The principal reform effort in the sector has focused on agricultural trade policy. In 2001, the maximum tariff was reduced from 40 percent to 30 percent, and the tariff structure was simplified. However, most agricultural commodities continue to benefit from the maximum protection rates of 20 percent and 30 percent, and trade policy remains a major form of support for producer prices. Additional unit tariffs, which were imposed on top of the *ad valorem* tariffs, have been reduced from a maximum of about 20 percent (tariff equivalent) to 15 percent. However, new temporary export license requirements were imposed in response to the drought of 2003.

27. The Government plans to develop a new law on cooperatives, which will help restore their ability to reduce input and marketing costs, and provide agricultural credit. While cooperatives have been an active element in the republic since the late 19<sup>th</sup> century, actions of the prior government destroyed much of their capital. The Government also plans to draft a national rural development plan, including the establishment of an Agency for Rural Development. This agency will focus on the problems of the republic's numerous small farmers. The Government also plans to improve the profitability of agriculture and the food industry by providing technical, management and marketing advice to farmers, food processors and traders. An additional need is the rehabilitation of the irrigation system. The Government has already earmarked E40 million for this purpose. The Ministry of Agriculture has also drafted new modern laws on veterinary services and plant health protection, and is drafting several other key pieces of agricultural legislation which are expected to be finalized by the end of 2003.

28. **Montenegro.** Agriculture in Montenegro is heavily concentrated in livestock and fisheries. Nevertheless, the republic produces only 60 percent of its needs, and is a net importer of meat, dairy and cereals. There are few subsidies, and price controls on milk were recently removed. A large one-fifth of the Government's budget for agriculture goes to provide pensions for farmers. A previous weak extension system has been reformed to bring better linkages with research institutes, and to provide workers with greater mobility. Likewise, the Inspection Service for veterinary and phyto-sanitary areas has been upgraded. Recent legislation has helped to set quality standards and provide regulation for fisheries and olive growing. The lack of agricultural credit remains an important constraint, as does the shortage of processing capacity for export products.

## **Energy**

29. The energy sectors in both republics suffered from a variety of problems prior to the reform period, including underpricing of services, lack of adequate maintenance and investment expenditures, lack of competition, excessive employment and a resulting large fiscal drain on government resources. An additional factor in Serbia was the destruction caused by the conflict of 1999. As a consequence, there were frequent shortages in supply and unsustainable functioning of the electric power companies in both republics. Significant steps have been taken to reform institutions and restore financial viability to the sector.

30. **Serbia.** The Government of Serbia has made extensive efforts over the past three years to rehabilitate key sector assets, repair war damages, and restore a reliable supply of energy. Through a series of tariff adjustments, the average price of power was increased from 0.9 cents per kWh at the beginning of 2001 to nearly 4 cents per kWh at present. In parallel, the state-owned electric utility, EPS, has taken steps to contain its operating costs, including its real wage bill. The number of employees in the core business has been reduced by around 900. About 20 subsidiary enterprises have been separated out of EPS and are slated for eventual privatization. The ratio of collections to new billings has improved from about 60 percent in late-2000 to 87 percent during the first eight months of 2003. The combination of bold reforms to improve finances of EPS and major donor-financed plant improvements has reduced winter electricity outages from 56 days in 2000/01 to zero in 2002/03. In parallel, the quasi-fiscal deficit created by EPS has been reduced from 10 percent of GDP in late-2000 to about 4 percent in 2002. While present electricity prices are close to operating costs, a price of about 5 cents is likely to be necessary to cover long run marginal costs and eliminate the quasi-fiscal deficit. The planned combination of separation of entities and declaration of redundancies, will lower total employment in EPS from 58,000 in 2000 to 33,000 by 2005. EPS still continues to pay the wages of more than 7000 employees that worked in Kosovo before the conflict of 1999.

31. Driven by the objective of EU accession, the Government plans to expose energy entities to regional competition in the South East European Regional Energy Market (SEEREM) for both gas and electricity, and later to competition in the large EU market. A crucial new Energy Law, expected to be considered by Parliament in late 2003, will open up the electricity market to foreign competition, and give independent producers access to the transmission system, which will be taken out of EPS and made an independent entity. A new independent agency will be set up to regulate the sector, which will improve governance and provide a framework for private investment in the sector. Efforts to increase the efficiency of energy use are being addressed by a new Energy Efficiency Agency.

32. The existing block tariff system provides highly subsidized electricity to low-level customers, which represent 70% of the total. These tariff blocks need to be adjusted so that the implicit cross-subsidy is directed to poor households.

33. **Montenegro.** The sector suffers from a shortage of capacity, as no new major production investments have been made in the last 20 years. Local production is approximately 2/3 hydro and 1/3 coal fired thermal. Thermal plants are very inefficient and have emissions levels well beyond EU standards. Montenegro imports about 30 percent of its needs (depending on rainfall and hydro production), largely due to the consumption of KAP, the large aluminum producer, which uses nearly 40 percent of the total. In 2001, Montenegro suffered from drought-induced electricity blackouts both in summer and winter seasons. Recent efforts have been successful in improving the situation. Prices were increased by 23 percent in 2003, and now average about 4.6 Euro cents per kWh. However, electricity sales to KAP are currently set at 2 US cents per kWh, well below marginal cost. The publicly owned power producer, EPCG, is currently in the initial stages of functional unbundling with the eventual goal of separation of transmission, distribution and production aspects. The new EU compliant Energy Law passed in July 2003 establishes an independent regulator and sets the stage for regional and European integration. The new agency will be empowered to issue licenses for production, distribution and transmission of power, and

to set rates. Efforts are being made to identify renewable, non-hydro energy sources, and well as the possible use of small hydro projects to close the energy gap. Prices need to be further adjusted towards full cost recovery levels, with implicit cross-subsidies more carefully targeted to the poor.

## **Transportation**

34. As in energy, the quality of transport infrastructure had deteriorated in the period preceding the reforms, as of a result of mismanagement, conflict in 1999, weak institutions, unsustainable tariff and financial policies, and misuse of funds. The capital stock was not maintained, and there was under-investment in rehabilitation, so that the quality of transport infrastructure is lower than in most neighboring countries. An adequate transport network is an essential prerequisite for sustained economic growth and integration with the European Union.

35. **Serbia.** During the past two years, the Government of Serbia has started needed institutional reforms, and rehabilitation/reconstruction of equipment and infrastructure. Changes in management in state agencies and enterprises have led to better planning, and control of functions within the sector. Institutional reforms included the preparation of many important laws for the functioning of the sector, including drafts laws for railways, roads and road transport. The draft law on road transport will clarify the relationship between the Ministry of Transport and the Road Directorate, placing the policy formulation functions with the Ministry.

36. The reconstruction of roads has been initiated with support from bilateral and multilateral donors and creditors. In 2002, 800 km of roads were repaired and this pace has continued into 2003. A Road Recovery Program is being designed to define priorities and future needs. The Road Directorate is moving to institute a new system of maintenance based on performance targets. However, more attention needs to be given to ensuring sustainability through funding adequate levels of maintenance, in order to stop long term deterioration in the network. The Government also needs to adjust its system of road user charges.

37. Physical rehabilitation of the railways also started in 2002, especially along Corridor X, which links Greece with other Member States of the EU. Due to a still significant backlog of maintenance and upgrading, much more work will be needed in the future. In addition, the very limited efforts to date at restructuring and financial strengthening of the state railways company (which is a major direct and indirect drain on the government budget) will need to be significantly accelerated through concerted measures to cut costs and raise revenues. Air transport faces similar problems. A major reconstruction is needed of the airport in Nis, which was destroyed in 1999. There is also a need to improve public transportation within larger cities.

38. **Montenegro.** Initial conditions of transport sector in Montenegro were similar to those in Serbia – institutional and regulatory weaknesses, deteriorated assets, etc. Reforms within this sector were heavily supported by multilateral donors and included technical assistance for development of regulatory bodies and rehabilitation/renewal of infrastructure and equipment. Transport is an important issue for Montenegro which needs to reestablish links with neighboring networks and increase the use of installed capacities (e.g. the Port of Bar).

39. The Government is taking steps to bring better organization to the roads sector. A new draft Roads Law would consolidate and coordinate roads planning and expenditures. At present, these responsibilities are divided between the Ministry of Public Works, the Directorate for Highways, and the Ministry of Transport. The result is an imbalance between construction and maintenance, and the lack of proper planning for new road construction. An Air Traffic Control agency, jointly owned with the Republic of Serbia, has been set up to bring this operation up to European standards. Likewise, a new Maritime Safety Agency has been established to regulate shipping, including ship inspections, navigational aids, search and rescue, and ecological controls, again in keeping with EU standards. A new law for railways is proposed, which will separate the maintenance of the infrastructure from the operations of the railway, opening up the possibility for the eventual privatization of the latter. An efficient railway operation is seen as essential to maintain operations at the Port of Bar, which is now working at only 20 percent of capacity.

### **Telecommunications**

40. **Serbia.** Reform in the Information and Communications Technology (ICT) sector, especially telecommunications, is being driven by the EU accession agenda. The new telecommunications law was drafted taking into account the *acquis communautaire*. In recent years there has been a focus on rebuilding the ICT infrastructure but the effective monopoly held by Serbia Telecom and the lack of a clear regulatory regime has not been conducive to fostering private sector investment. As a result, the fixed telecommunications network in many areas is inadequate in terms of the supply of basic telephone services, let alone sustaining broader based economic development.

41. At a detailed level, there is lack of clarity in the regulatory regime and inadequate transparency in the regulatory processes. Asymmetric regulatory decisions between the mobile operators and the absence of an effective dispute settlement procedure are other areas of concern. In combination, these features of the regulatory regime act as a brake not only to the development of the ICT infrastructure but also to internet access and service development which represent the cornerstones of e-commerce development.

42. **Montenegro.** A new telecommunications law, broadly compatible with EU requirements, was adopted in 2000. This law established a fully competitive environment from January 2004. Recent investment in the basic telecommunications infrastructure, both fixed and mobile, has resulted in a relatively well developed network in terms of digitization and capacity. Future reforms of the sector will be concentrated on changes in market structure including the ownership/privatization of Montenegro Telecom and the requisite strengthening of the regulatory processes.

### **Environment, Water and Waste Management**

43. **Serbia.** Environmental management continues to suffer from an inadequate legal framework, overlapping competencies, limited institutional capacity and lack of investment funds for core problem areas. The latter include: lack of adequate management of waste, notably hazardous industrial waste; pollution of surface and groundwater bodies; severe air pollution in

large cities and industrial areas, particularly near lignite-fired power plants and associated mines; deteriorating drinking water quality; and the lack of adequate sewerage, especially in poor urban settlements. Nevertheless, since 2001 the Government, supported by donors, has taken initiated significant steps towards harmonizing its environmental management system with EU directives.

44. In the spring of 2002, the Government approved a Law on the System of Environmental Protection. The enactment of this law will be crucial for the establishment of a credible legal basis for improved environmental enforcement. New laws that deal with forestry, waste, and water are also in the pipeline, as well as by-laws on environmental impact assessment and strategic environmental assessment, integrated pollution prevention and control, and public participation. The Government recently also approved a National Strategy on Waste Management. A National Environmental Action Plan (NEAP) and four Local Environmental Action Plans are being prepared. The NEAP will have a special focus on stakeholder participation in prioritization and identification of funding sources for the priority actions.

45. The draft Law on the System of Environmental Protection provides, *inter alia*, the basis for the establishment of an Environmental Protection Agency (EPA), which is an essential element for strengthening compliance and enforcement. There will be donor support to build capacity in the EPA, but the critical issue of adequate staffing and competitive salaries will require Government attention in the larger context of civil service reform. Another crucial issue for effective enforcement will be the streamlining of EPA competences with those of related agencies. This is particularly the case for the *water management* sector.

46. **Montenegro.** The main environmental problems remain: severe air, water and soil pollution by a few large hotspot industries, mines and power plants; lack of satisfactory waste management and of wastewater treatment threatening the Adriatic coast and inland water bodies; shortage of drinking water in coastal areas during the summer months; limited public awareness on environmental protection, shortage and low quality water supply and appropriate sewerage in some rural areas, and recurring floods that have increased in severity in recent years

47. Since 2001, some structural measures have been taken that will improve environmental protection. In some cities, notably Podgorica, tariffs for municipal wastewater and waste collection have been increased to levels that are closer to covering operating costs. This has helped improve the quality of services. The Government is developing strategies for waste and wastewater management. It is also developing by-laws on environmental impact assessment and strategic environmental assessment, integrated pollution prevention and control, and public participation.

48. Even with these advancements, there is still a serious need for capacity building for environmental management and for cooperation among governmental agencies. Adequate water and sanitation facilities are a limiting factor for the coastal tourism sector. Environmental concerns need to be incorporated into the privatization process of heavily polluting industries, particularly the aluminum smelter in Podgorica and the ironworks in Niksic.

49. In both republics, *water and sanitation sector* priorities are recovering from the last decade of neglected maintenance and almost no new investments, with an emphasis on

improving service quality, safety and reliability. The efficiency of municipal utilities in charge of providing water and sanitation services needs to be improved, including through corporatization and separation from other municipal services. Greater efficiency and accountability would reduce the current substantial operating deficits of these utilities, thus improving their sustainability and capacity to contribute to investment needs. Increased private sector participation, particularly in larger cities, would also contribute to these goals. In *Serbia*, private sector participation may be feasible and effective in addressing some of the problems in the water and sanitation sectors of the larger cities. In *Montenegro*, improved coastal water quality and services, as well as the protection of important natural assets that form the basis for the tourism sector, are essential elements of the "business environment" and important building blocks for sustained growth in the short and medium term.

### III. Public Sector Reform/Governance

#### Public Sector Reform

50. In both republics, the need to improve the efficiency and transparency of the public sector is a high priority. A decade of politicization and centralization of authority, combined with economic collapse and the outflow of educated and skilled people have left most public institutions in a very poor state. Frequent changes in regulations and institutions through non-transparent processes, little strategic planning, widespread corruption, and misuse of state institutions for political purposes all made public administration highly inefficient and a serious impediment to private sector growth.

51. Independent surveys of the business climate in SaM frequently point to serious concerns related to governance and corruption. SAM Authorities have begun to redress this legacy, and have taken steps to tighten financial controls and increase surveillance. Nonetheless, perceptions of corruption and the lack of financial transparency remain serious problems, and the magnitude of the challenges which lie ahead is daunting.

52. *Serbia*. Ever since taking office, the Serbian government has identified public administration reform and improvements in governance as high priorities, equal to the need to reduce poverty and raise living standards. While there are positive achievements to report, particularly in public expenditure management, the pace of reform efforts so far has been below expectations. In 2002, the Parliament approved the Law on the Budget System, which is critical for a range of reforms and institutional changes to improve budget formulation, execution and control. These changes include establishing a more comprehensive medium term framework for budget formulation, improvements in budget execution (including the establishment of an interim treasury, and tighter controls over spending and new commitments), and greater accountability based on enhanced budget inspection and internal audit. In addition, the public procurement system was somewhat improved through the enactment in 2002 of a new Law on Procurement. However, further modifications to the legal framework are necessary, and the capacity of the new Public Procurement Agency needs to be significantly strengthened. The Parliament has also passed new laws on money laundering, combating organized crime, and the establishment of an ombudsman. However, laws related to establishment of an anti-corruption

agency, conflict of interest, and civil servant code of conduct, have stalled in the drafting process and have not yet been sent to Parliament. The Ministry of Finance and Economy has completed an inspection of all major government agencies and social funds, and its report was submitted to the Serbian Parliament. This report uncovered numerous cases involving possible criminal offenses. However, the public prosecutor has yet to move on most of these criminal cases.

53. The lack of progress in public administration restructuring and civil service reform is a cause for serious concern. Whereas donor-funded replacement capacity has filled some immediate gaps, the method through which this was achieved is unsustainable. The availability of significant donor funding without related conditionality has left Serbia with a largely unreformed public administration system which hampers its ability to implement economic and social sector reforms. This is both due to the lack of capacity in the middle and lower ranks of the administration and to weak incentives for better performance. The recent transfer of functions from the State level put further near-term pressure on the public administration system, which had to accommodate a large number of new functions, as well as on the Serbian budget. However, this is likely to pose mainly a temporary challenge. Finally, the policy-making system remains highly fragmented, with low inter-ministerial coordination capacity and a largely administrative Government Secretariat.

54. The Government has recently shown awareness of the urgency of addressing weak public sector management capacity by initiating a reform of the management structures for public administration reform and re-launching the stalled process of developing the public administration reform strategy. The strategy should provide the basis for the implementation of a more consistent and effective public administration reform policy and create in the medium term the necessary capacity in the administration to effectively implement economic and social sector reforms.

55. *Montenegro.* Montenegro started the process of reforming its administration as early as 1998. However, the process stalled during the conflict in 1999 and the subsequent period of political instability in the republic. Following the formation of the new government, the reform process was re-launched. Montenegro's small size makes it particularly crucial to improve the efficiency of public administration, as a large civil service will be unaffordable, but experience to date shows that weak state capacity has been a major barrier to effective implementation of policies and reforms.

56. The welcome adoption of the public administration reform strategy and Law on Public Administration in summer 2003 provides the policy and legal framework for far reaching reforms in the public administration system. In April, 2003, the government announced a plan to reduce public employment by 3,500, with an initial reduction of 1,000 this year. These redundancies will largely take place among police and teachers, which constitute the bulk of public employment. In addition, the Government is taking other steps to improve public administration, including the implementation of a new system to monitor budget execution and management. However, the long awaited establishment of internal and external audit functions has experienced significant delays.

57. The Law on Ombudsman put in place a new independent oversight institution, with a broad mandate. The office is currently being set up. The institution could potentially make an important contribution to the fight against corruption, as it can investigate charges on abuse of office.

58. A further package of legislation, governing both the internal management of the civil service and the accountability regime, is scheduled for parliamentary action in late 2003. This includes the Civil Service law, the Law on Salaries, and legislation to establish the administrative justice system. The Law on Civil Service will establish a clear system for selection, promotion, and job descriptions in the civil service, and set up a Human Resources Agency to administer personnel matters within the Government. However, one key concern is whether the Montenegrin budget will be able to accommodate the creation of a large number of new institutions at this point in time.

### **Privatization/Enterprise Reform**

59. Most of the companies in Serbia and Montenegro (like in other ex-SFRY republics) were organized as socially-owned, with ownership rights divided between employees, managers, and pensioners. This was one of the main reasons for enterprise inefficiency, misuse of funds and slow implementation of pro-market reforms. The first attempt to change social ownership was in 1989, when the first Yugoslav law allowed firms to be privatized by employees, at their initiative. In 1994, an amendment of the privatization law changed the privatization rules, resulting in popular discontent, extensive litigation, and a halt to the privatization process. In July 1997, the Serbian Government adopted the Act on Ownership Transformation. Once again, employees were given a right to decide whether or not to initiate privatization. As a result, shares in firms were distributed for free, or sold at a large discount, with 90 percent going to employees and pensioners.

60. *Serbia.* Under the Privatization Law passed in June 2001, the Privatization Agency (PA) and the Ministry of Economy and Privatization have the mandate to sell about 2000 socially-owned enterprises. The law authorized the PA to adopt three approaches: privatization by tender for large enterprises, auctions of small and medium enterprises, and restructuring and subsequent tender/auction for larger enterprises that cannot be sold in their current condition. Significant progress has been made, with a total of 1113 enterprises offered for sale, and 895 sold (as of October 2003<sup>4</sup>). The bulk of these have been sold under auction, where domestic natural persons can take up to six years to make payments, without interest.

61. About two-thirds of privatization revenues have so far come from the larger firms sold through tenders. Tender sales have been going more slowly, in part because these enterprises often have high debt levels, excessive employment, and in some cases excessive commitments to expensive social programs. A group of 49 socially-owned enterprises has been identified for intensive restructuring to bring their balance sheets to a position of positive net worth, if possible, or to be privatized by sale of assets. The PA has been working with creditors to establish viable settlement strategies that would enable privatization to go forward along with a program of new investment from strategic investors. Social programs for redundant workers are

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<sup>4</sup> Of the total of 895, 140 represent share sales of minority government interests held in the Shares Fund.

normally a part of the package, giving redundant workers severance payments greater than the amount required by law. Given their precedent setting and fiscal effects, and their crowding out of better targeted social programs, such relatively generous severance packages are a source of concern. Revisions in the law passed in March 2003 have simplified the whole process by making it easier for buyers to acquire these assets, and reduces the requirement to retain redundant workers.

62. Major privatizations have included the sale of three cement factories, the fuel retailer Beopetrol, and two large tobacco companies. The significant increase in privatization revenues in 2003 partly reflects the granting of *de facto* tariff protection and other barriers to competition in key sectors. Adherence to the principles of openness and transparency in all privatizations will be crucial for a successful completion of the program. Despite progress with industrial enterprises, there has been very little progress in restructuring and privatizing large public corporations in infrastructure and transport, such as those for electricity, oil and gas, railway, airlines, and telecommunications. These enterprises create major fiscal pressures and have high levels of excess employment.

63. **Montenegro.** In Montenegro, privatization has occurred through the issuance of vouchers under the Mass Voucher Privatization (MVP) program and through direct sale via tenders and auctions. About 40 percent of industry remains in state hands, although the Government's target is to sell several large companies by the end of 2003. In 2002, the Government sold 54 percent of the oil company Jugopetrol Kotor. Tenders have been prepared for large enterprises including major units of the giant aluminum conglomerate (KAP), the Niksic steel company, and the tobacco company. The government has offered 13 hotels for sale, of which nine have been sold. A tender for the state telecommunications monopoly was not taken up, possibly reflecting general problems with the global telecommunications market. This enterprise will be probably re-offered next year. The MVP program unfortunately generated many problems, since it fragmented ownership, which in turn blocked changes in corporate governance and made it more difficult to bring in strategic investors with fresh capital. The bulk of the shares for most firms remained with the Government and its share funds, including the Pension Fund. The Government is designing a program to address these issues, partially through assistance to companies to cover redundancy costs, through restructuring of state debt, and through the reorganization provision of the new bankruptcy law.

## **Judicial Reform**

64. The authoritarian regime prior to 2000 left the judicial system very weak, and opened the way for arbitrary decision making and abuses. The corrupted and inefficient court system became one of the main obstacles for development of democracy and market economy during the 1990s. Prosecution and adjudication decisions were highly politicized, since the government directly influenced the prosecutor's office and judges. While SAM had long tradition of commercial law litigation, the system of commercial courts was not appropriate for a modern market economy and did not enjoy the confidence of business people.

65. **Serbia.** In early 2002, the Government enacted five laws intended to bring the judicial system to European standards. These included the Law on Courts, which draws a line between

judicial authority and executive and legislative authority. It also introduces a Court of Appeals and Administrative Tribunal. Other laws regulate the status of judges, guaranteeing their independence. A High Judiciary Council has been established to regulate the nomination of judges and prosecutors. Overall, although the judiciary appears to be operating more independently and effectively than in the past, problems remain, particularly with the commercial courts which still need more work on modernization of procedures and changes of staff. Large civil backlogs continue to exist.

66. **Montenegro.** In December 2001, the Montenegrin Parliament enacted a new Courts Act, which makes significant changes in the structure and operations of the judiciary. Under the new act, two new courts, an Appellate Court and an Administrative Court, are to begin operations no later than July 1, 2004. Both courts are designed primarily to relieve caseload pressure on the Supreme Court, which currently is required to handle large numbers of appeals from all courts in the system. This overload has adversely affected the ability of the Supreme Court to dispose of appeals in a timely manner and has slowed the issuance of necessary supervisory guidance from the Supreme Court to the other courts. The new Appellate Court will serve as an intermediate appeals court between the Supreme Court and the Superior, Commercial and Basic courts. The new Administrative Court is to serve as the locus for the review of final administrative actions from government agencies.

67. The Courts Act also changes the structure and operations of the Judicial Council, which is responsible for a variety of functions relating to the election, removal and discipline of judges and lay judges, defining responsibilities regarding the functioning of the courts, determining the number of judges and lay judges for each court, and for proposing the budget for the courts. The Council's responsibilities with regard to election, removal and discipline of judges, as well as the procedures to be followed in each case, are spelled out in detail in the new law. Planning for the implementation of these changes is currently at a very preliminary stage within the government. There are a number of issues that need to be resolved, including space, personnel, equipment, training and other requirements.

#### **IV. Reforms in the Social Sectors**

##### **Education**

68. Both Serbia and Montenegro see improved education as fundamental to raising labor productivity and reducing poverty in the long run. While both have accomplished much in education, including nearly 100% primary enrollment, the education system continues to suffer from a lack of relevance to the labor market (particularly in secondary and higher education), inefficient resource allocation at all levels, dilapidated infrastructure, limited capacity in monitoring and evaluation, and overly centralized and outdated management structures. In addition, there are issues involving the participation of certain groups, such as the Roma and the IDPs.

69. **Serbia.** Education reform has been a key priority of the Government, as expressed in the PRSP and elsewhere. The republic has achieved near universal primary enrollment, but still has

problems meeting the needs of minority groups, especially the Roma population. Serbia's success in targeting resources on both improved quality/relevance and on disadvantaged populations will be contingent on finding efficiency gains, particularly in the secondary and higher education sectors. Both relevance and inefficiency issues in secondary education are related to the over-specialization of many programs and the lack of broad-based skills and competencies for secondary age children. In higher education, relevance and efficiency problems are caused by the fragmented university structure, low graduation rates and the fact that many students – who tend to come from the highest socio-economic levels -- receive free admittance and/or state subsidies and have little direct incentive to limit the duration of their programs or choose programs with economic relevance.

70. The Government has developed an education reform strategy through consultations with stakeholders and drawing on international expertise and experiences. The first wave of this strategy focused on: decentralization and democratization; curriculum reform at primary and secondary levels; assessment and evaluation; teacher training; and improvements in vocational education. In the area of decentralization, the first major reform was the establishment of school boards with representatives of parents, teachers and the local community. The school boards were given authority to select school principals. In addition, the Ministry of Education and Sports has been reorganized and strengthened both at the central and at the regional level, and a better information system is being put in place with World Bank funding. The new Law on Education, adopted on June 2003, provides a clear legal framework for the decentralized governance of education, and a system of professional development and licensing of teachers. A major curriculum reform is being phased in at the primary school level, focused on ensuring learning outcomes through the implementation of student-centered teaching/learning approaches. Elementary education has been extended to a nine year program including compulsory and elective subjects. Steps have been taken to modernize the curricula in secondary vocational education, with a goal of integrating general and technical subjects, and setting the stage for life-time learning and improved mobility of the workforce. Following these efforts to modernize the curriculum, upgrading the skills of teachers to deliver these new programs are the highest priority. A Strategy for Roma Education was presented for public discussion in October 2003.

71. Reforms in tertiary education have increased the flexibility in course and subject selection as well as the emphasis on science and technology. Much remains to be done, however, in terms of restructuring management at the University of Belgrade and improving the efficiency of public resource allocation. A new National Standards and Evaluation Center will focus on evaluation and outcome monitoring, modernizing student assessment, and establishing national standards for assessment and examination.

72. **Montenegro.** Given its common roots, Montenegro's education system shares many of the strengths (nearly full primary enrollments) and weaknesses (lack of relevance, inefficiencies, lack of monitoring and evaluation capacity, etc.) of the Serbian system. While an education law has been passed, it is not as focused on decentralization as in Serbia. There have been excellent stakeholder consultations on education reform, and the PRSP and the Government's strategy document give a useful examination of the problems and possible solutions, including decentralization, teacher training, and curriculum reform. However, the Ministry of Education lacks both the institutional capacity and investment funding required to implement the desired

reforms. As in Serbia, Montenegro should be focused on promoting better efficiency in secondary and higher education so that resources can be freed up to support quality and relevance, and to target disadvantaged groups. In order to achieve economies of scale, Montenegro could focus on regional cooperation, particularly with Serbia, to promote its reform efforts and make it more viable for donors to support such a small population.

## **Health**

73. Health services in Serbia and Montenegro were always the responsibility of republican governments. By the end of 1980s, they reached a relatively high level of quality. With overall crises in the country, this sector suffered as chronic fiscal pressures left health prevention programs under-funded, equipment and buildings became dilapidated, and the supply of most of basic pharmaceuticals and materials was irregular and insufficient. All of these severely affected the working conditions for medical staff and the quality of health services provided, especially to the poor.

74. *Serbia.* Serbia's health care system still suffers from chronic fiscal imbalances. Efforts to stabilize it are needed both on the revenue and expenditure sides, and also need to focus on efficiency improvement to ensure continued access to and quality of services. Public spending on health was estimated at close to 7 percent of GDP in 2001. Once estimates of private expenditure are added, total health expenditure would range between 9 and 11 percent of GDP, among the highest in the region. Financing is done via a combination of compulsory public health insurance and private out-of-pocket payments by patients. The cornerstone of the public system is the Health Insurance Fund (HIF) which receives earmarked payroll contributions from employees, employers, self-employed, farmers and the Pension and Employment Funds. Transfers from the Republic budget are meant to cover health care provision for the uninsured, including the unemployed, refugees and IDPs. Budget funds also finance some capital investment, training and public health programs. In recent years, there have been arrears in payments of some transfers to the HIF, and the HIF, hospitals and health centers have accumulated debts to suppliers and run arrears in payments to utilities.

75. Health reform has been delayed because of a lack of continuity in ministerial leadership and fragmentation of responsibility for health policy and planning, and because health policy has not yet attracted high priority attention from the Government. Some initial progress has been made in tackling the problems of the sector, primarily in reducing arrears in health sector revenues and controlling HIF expenditure via contracts with public healthcare providers, though there are concerns that blunt expenditure control may have reduced patient access to care. In addition, extensive analytical work and consultation over health policy and strategy has taken place. Other important reforms have included the adoption of a new and more limited drug list for publicly financed drugs, and the introduction of co-payments for selected health services. However, further efforts need to be made to eliminate the extensive exemptions on co-payments which are not well targeted to the needy. In addition, the Government has sent to the Parliament new pharmaceuticals law that will increase access and competition in the market, and strengthen quality and safety regulation.

76. A major issue yet to be addressed is the inefficiency and inequity in the health care delivery network. Many hospitals have low capacity utilization and inefficiently configured infrastructure. There is overstaffing and low productivity, particularly among non-medical staff, and sub-optimal distribution of staff (areas of shortages in some places, with overstaffing in others places).

77. **Montenegro.** Montenegro's health system faces challenges in finance and governance, and in the delivery of health services. Public and total health expenditures are high (public expenditure was 7 percent of GDP in 2001 and estimated total health expenditure about 10 percent of GDP). The level of expenditure per capita at around US\$150 in 2002 is low, although it is higher than in Serbia, Bosnia-Herzegovina, or FYR Macedonia. The current public health financing and delivery system is not financially sustainable due to problems of inadequate revenues, arising from contribution waivers, difficulty of collecting contributions from small businesses, farmers and the informal sector, and lack of adequate budget transfers for the uninsured, including refugees and IDPs. In addition, there has been a failure to adjust the generous benefits package and capacity to reduced economic circumstances. Pharmaceutical expenditure has grown rapidly in recent years and now stands at a very high almost 30 percent of HIF expenditure, plus widespread out-of-pocket payment. Montenegro's health sector institutions have limited capacity for policy-development, planning, forecasting, managing and monitoring the system, and information systems and data for these functions are weak.

78. The Montenegro Ministry of Health and Health Insurance Fund have developed a Health Sector Strategy to address a number of these issues, and the Health Insurance Fund has embarked upon information systems investment to support improvement in revenue collection and control of pharmaceuticals expenditure.

79. Although Montenegro has achieved substantial improvement in health indicators for the population, there has been some stagnation or decline in key health indicators in recent years. A particular challenge is that of meeting the health needs of the high number of refugees and IDPs, including many Roma, that entered Montenegro following the Bosnia and Kosovo crises. The Ministry of Health is in the process of developing new laws and policies to respond to a number of these issues, including new laws on health care, health insurance and pharmaceuticals and medical devices. It is planning substantial investment in development of primary health care, and is developing plans for upgrading the Institute of Public Health, and for developing mental health services.

## **Pension Reform**

80. Both republics have suffered from a heavy burden of pension obligations, as a result of an overly generous pension benefit scheme combined with an aging population, growing informal employment, and an inadequate tax base. General economic crises led to an accumulation of arrears towards pension funds since entitlements were not adjusted in line with reduced resources, and since many employers, particularly large state enterprises, were not able to pay contributions for their employees. This constellation of adverse factors led to large deficits in the pension funds that had to be met from general budget revenues.

81. Both republics have taken important steps to reform their pension systems, in the first step focusing on reformulating the parameters of their PAYGO systems. Reforms in both republics were designed along the similar lines and included increase in pension retirement age, widening of the calculation period, lowering the accrual rates through introduction of a point-based formula, reducing the generosity of indexation, transferring or eliminating many non-pension benefits, and tightening eligibility for disability.

82. **Serbia.** One fifth of the population of Serbia receives pensions, and the ratio of active contributors to pensioners among employees was 1.35:1 in 2002. Pension outlays (excluding military pensions and health contributions) totaled about 13 percent of GDP. Prior to launching a pension reform package, the contribution rate was lowered from 32 percent to 20.6 percent of salaries. The bold changes to Serbia's PAYGO pension system, introduced through two rounds of reforms in 2001 and 2003, rank among the most important achievements so far in Serbia's overall reform program. Specific changes included raising the retirement age limit by three years to 63 for men and to 58 for women. Benefits are indexed by a combined index of wages and prices (Swiss formula), and pensions are now based on life-time earnings. A minimum pension of around 20 percent of the average gross salary was also established. Benefit rules for disability pensions were also tightened. Over time, these reforms are expected to reduce the cost of the pension program by 2 percent of GDP, but still leave a deficit.

83. Serbia remains the only economy in the region with three separate PAYGO funds; workers, farmers and self-employed. Only the Self-employed Fund is current on pension benefits, while the others have arrears ranging from 1.5 months (workers) to 16 months (farmers). The government has been considering the possibility of merger of the three funds to promote efficiency. The pension reformists in Serbia will have to consider the pros and cons of further reform of the mandatory system. The government has already fostered work on introduction of a voluntary pension pillar.

84. **Montenegro.** Pension expenditures equal about 13 percent of GDP, and there are 1.3 workers for one pensioner. Wage taxes for social security account for 24 percent of salaries (employees 12 percent, employers 12 percent). However, contributions cover only 60 percent of pension costs. After significant delay, a reform law was passed in September 2003. This law puts forth certain parametric reforms of the PAYGO system, most notably a five-year increase in retirement age (to 60 and 65 respectively for women and men, to be phased in over ten years), indexing (Swiss formula of wages and prices), and benefit calculation (move to a point system). Benefits will be based on total lifetime contributions, not the most recent 10 years, but this reform will be phased in over 15 years. The introduction of some funded elements is expected to follow. Even with the reform deficits from the system will continue, in part because the reforms are phased in over time, and in part because of the need to pay veteran and other special pensions.

### **Social and Child Protection**

85. Both republics retained the key features of the former Yugoslav social welfare system, though in Serbia, in particular cash transfers became increasingly dysfunctional during the 1990s. Like other sectors, social and child protection suffered from chronic lack of finances

which led to decrease of average benefits paid and an accumulation of arrears. Efforts have been made recently to target benefits to the poor, and eliminate duplication.

86. **Serbia.** Total social assistance and child assistance expenditures equal about 1.2 percent of GDP, lower than in most other countries in the region. The main social assistance benefit, Material Support for Families (MSF, or MOP in Serbian), is aimed at individuals and families whose income is lower than the guaranteed “social security level”. Only about 40,000 households currently receive the MSF, compared to about 230,000 households below the poverty line. Decentralization of eligibility thresholds for social assistance has contributed to low coverage rates in poorer areas. In 2001, the Ministry of Social Affairs (MOSA) introduced some temporary corrections to increase the size of the MSF in these areas. In 2002, the MOSA proposed legal amendments to introduce a republic-wide eligibility threshold and index benefit levels to the cost of living. These changes are expected to increase the number of welfare beneficiaries to about 53,000. In addition, they will increase benefits for over 20,000 household with seriously disabled members in need of regular care in the home. The government has recently introduced emergency measures to mitigate the negative impact on the very poor and vulnerable households of rising utility prices. This includes new cash benefits during the heating season to around 46,000 households with seriously disabled members, and selected poor households with low energy use.

87. The system of child support provides cash grants for children of poor families. About 500,000 children (160,000 families) benefit from the program. A new law on financial support to families with children improves targeting of the child protection system, allowing adequate and sustainable benefits for children from poor households. The new law aims to strengthen support to children through promoting equal access throughout Serbia, tightening targeting of child allowances, maintaining the real value of support to poor families, and reducing the duplication of benefits. It seeks to eliminate any overlap between the social assistance and child protection programs. The effect is expected to be a reduction in the number of beneficiaries, and a lower level of overall expenditures.

88. In the past, during the Government’s financial crisis, many social payments were delayed. In 2001 and 2002, the Government established, with donor support, a special “one-off” fund which allowed it to clear arrears and increasingly bring payments up to date.

89. **Montenegro.** The republic has a system similar to that of Serbia, and spends about 6 percent of its total budget on social protection activities (excluding pensions). The main program is also the MSF. Eligibility includes those who are unable to work, who have no family to support them, or who must support minor children. Eligibility depends on a family’s size and income relative to the average wage. For instance, a family of four is eligible if their income is less than 70 percent of the average wage. The maximum benefit is 95 Euros per month for a family of five. The MSF income supplement is designed to bring their total income up to the eligibility amount. About 10,000 families currently receive the benefit, an increase from 8,000 in 2001. This increase was largely due to a liberalization of eligibility in 2001 to include those who are capable of working but must support minor children.

90. The system of child protection initially provided child allowances to all families with children. Changes introduced in 2001 limited this benefit to those under the MSF, so that the number of beneficiaries was sharply reduced, but limited therefore to those who were poor. For the future, the Government will introduce new legislation which will further unify the two programs, integrate these programs better with the work of NGOs, and provide for greater decentralization to municipalities.

## Conclusions

91. The reform process has made significant progress in many areas, particularly in macroeconomic stabilization, trade liberalization, privatization, bank resolution, pension reform and social protection. Major efforts have been made to open the country to foreign trade and investment, and adopt the practices of a modern, market economy. Ultimately, the goal is to invigorate the growth process, so as to increase income levels, reduce poverty and provide jobs for the unemployed. The past reforms have helped lay the basis for this economic recovery, and for an future association to the EU and WTO membership. However, in many areas the reforms are still incomplete, and in several areas the reform process has hardly begun. One of the highest priorities is the reform of the public sector, whose institutions are critical for the implementation of the overall reform agenda.

92. Key specific priorities for improving the **private sector incentive framework** include: adopting and implementing the new laws and regulation on business registration and bankruptcy (Serbia); taking steps to further reduce labor taxation, and to limit the impact of collective bargaining agreements on labor costs; completing an internal market between Serbia and Montenegro as laid down in the Constitution; achieving further multilateral trade liberalization; fully implementing the free trade agreements concluded with neighboring countries; completing the single foreign trade policy of the State, including establishing appropriate institutions; and agreeing on a timetable to harmonize remaining tariffs and other import charges.

93. Key priorities for strengthening the **productive, financial and infrastructure sectors** include: continuing with the privatization of financial institutions; harmonizing phyto-sanitary controls with EU standards; adjusting energy prices (including to large customers in Montenegro) so that only poor consumers are subsidized; bringing greater commercialization of the energy sector, including the establishment of an independent regulator; making more concerted efforts to restructure the state railways; and taking steps to replace deteriorated transport infrastructure.

94. Key specific priorities for reforming the **public sector** include: taking steps to reorganize and modernize institutions, including the establishment of a professional civil service; making further improvements in accountability and transparency; developing and implementing a sound anti-corruption strategy and its legal and institutional framework, including passage of laws governing conflict of interest (Serbia); making further progress on the establishment of an independent judiciary, including implementation of new laws (Serbia), and the passage of new laws (Montenegro); and completing the privatization and restructuring of industrial enterprises,

focusing on some of the larger and more difficult cases, using where necessary the new bankruptcy laws.

95. Key priorities for reforming the **social sectors** include: further reform of secondary and higher education, including efficiency enhancements; increasing efficiency in the delivery of social services, particularly in health; undertaking efforts to replace deteriorated health and education infrastructure; and reforming the administration of state pensions.