

OFFICIAL
DOCUMENTS

LN8491-4F



Republic of Serbia
MINISTRY OF FINANCE

No: 337-00-84/2015-24
February 23, 2015
20 Kneza Miloša St.
Belgrade

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

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

Dear Mr. Kim,

This letter summarizes in a selective manner critical aspects of the program that the Government of the Republic of Serbia is committed to undertake over the short and medium term to implement structural reforms of the state owned enterprise sector. The aim of the program is to improve the governance, transparency and accountability of SOEs that will remain in government ownership, restructure and divest from non-competitive enterprises, reduce fiscal burden imposed by the SOEs, contribute to improved business environment and competitiveness of Serbia's economy, while supporting and compensating those workers who will be adversely affected by this process.

Macroeconomic framework

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

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

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

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

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

Program of Reforms in the SOE Sector

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

Restructuring and Divestiture of Companies in the Privatization Agency Portfolio

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

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

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

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

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

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

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

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

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

- (i) A group of 188 companies with about 5,000 workers will be sent to bankruptcy by June 2015. In January 2015 we have adopted an Action Plan authorizing the PA to start initiating the bankruptcies in these companies as soon as workers have received social programs (financial compensation in lieu of severance packages). For 76 companies from this group the bankruptcy will be initiated immediately after the adoption of the Action Plan (i.e. in February), and for the remaining companies it will be initiated until June, once the social programs have been completed.
- (ii) For 147 companies, with about 24 thousand workers equity sale will be attempted. First public bids for these companies will be announced in late February.
- (iii) For 30 companies, with about 12 thousand workers asset sale model will be used. Programs for asset sales prepared by companies will be delivered to the PA starting in February.
- (iv) For 3 companies with about 3 thousand workers a mix of models will be used.
- (v) For 24 companies with about 29 thousand workers strategic partnership model will be used.
- (vi) For 19 micro companies with about 200 workers separate decision by the PA will be taken on privatization model.
- (vii) For 7 companies further valuation data is needed and this process has been initiated. Once this data is collected, a decision will be taken on model of privatization.
- (viii) In addition, there are 96 companies with approximately 15 thousand workers, for which the privatization process has been suspended. This includes companies based in Kosovo and Metohija, and companies which were founded by former Yugoslav republics. It also includes several companies where court cases are ongoing, and once they are completed the privatization is expected to be restarted.

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

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

Strengthening Governance, Institutional Framework and Transparency Arrangements for Public Enterprises

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

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

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

We will continue to strengthen the corporate governance framework for our Public Enterprises. This will include further defining the criteria, in line with the PE law, for dismissal and performance bonuses of Board members and managers. We will work on defining criteria to assess the performance of the management, aiming to clearly link the performance assessment to the achievement of key performance indicators that would be agreed to between the government and the PE in advance and publicly disclosed. Further, to accompany the process of corporatization envisaged in some large PEs, the legal framework should be further enhanced to ensure continued

adequate oversight of the corporatized state owned enterprises. The checks and balances provided for under the common corporate governance rules in the Companies Law do not provide sufficient comfort for the adequate supervision and functioning of the SOEs where the state is either a single shareholder or a dominant shareholder. State has shareholdings in numerous, important and complex companies, and given the status of administrative resources in Serbia, it is not realistic to expect the Government to perform the usual role of a diligent owner and shareholder in all such companies. Therefore, additional rules outside of the scope of the corporate governance rules laid by the Company Law, should be instituted to regulate SOEs so as to enable: (1) better control and supervision of SOEs by the Government (such as the obligation to submit to the government for approval the annual business plan), (2) increased transparency of SOEs activities and governance to the public (such as imposing on them the same transparency requirements as are currently required for all publicly listed companies), and (3) enhancement of the selection process of board members and key managers (such as a public procedure for the appointment of general managers). However, such rules should be designed so as not to significantly decrease SOEs competitiveness on the market.

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

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

Mitigating the Social and Labor Market Impact

Being fully aware of the high unemployment rate and unfavorable labor market situation, we have carefully designed significant measures to cushion the social and labor impact of our structural reforms. In particular, our goals are to ensure adequate financial support to workers that will be made redundant, and to facilitate the transition into employment and provide a temporary safety net for vulnerable redundant workers.

We have created a special budget-financed fund, the Transition Fund, which provides several options for financial assistance from which redundant workers can choose from in lieu of severance pay.¹ The 2015 Budget has allocated RSD16 billion (approximately EUR130 million) for this purpose, which based on previous severance programs could cover more than 20,000 redundant workers. In January, we have adopted a new Decree detailing the options available to workers, and aiming to offer adequate and equitable financial compensation, while addressing the issues on equity of the packages from previous years. Under the new Decree, the main package offers financial compensation as foreseen in the labor code, only taking into account work history with the last employer. This is an adequate package and also ensures equity between redundant workers in the public and private sector. Nevertheless, in order to avoid packages that could jeopardize financial sustainability of the proposed program, and to avoid abuse by workers that have high wages on record, but are actually paid less in reality, this package will be subject to caps. In particular, packages cannot exceed a total value of EUR 8,000 per redundant worker; and not more than 500 EUR can be accrued per year of service with the last employer. In addition, in line with past practice, a package of EUR 200 per year of service is being offered for the entire work history.² This package is targeted at low-wage earners who would receive relatively little under labor code provisions. A third option offers six monthly average wages to workers with a minimum of 15 years of work history. In addition, a certain group of workers, employed by the companies that will go into bankruptcy³, with long contribution histories would qualify for an old-age pension—albeit very small one—and therefore would not be eligible to any of the above financial compensation packages. For these workers, a small compensation of two monthly average wages is offered.

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

¹ The offered packages are not considered severance pay since workers voluntarily chose to leave the company if they sign up for the program.

² An additional provision ensures that no compensation is being paid for those years for which the worker has previously received severance pay.

³ 188 companies employing around 5,000 workers


⁴ In the past, many redundant workers received packages in access to labor code provisions, which disqualified them from receiving unemployment benefits.

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

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

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

Sincerely Yours,

MINISTER

Ph.D. Dušan Vujović