Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: January 31, 2018| Report No: 123391

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Serbia	P161184	Second Public Expenditure and Public Utilities Development Policy Loan	
Region	**Estimated Board Date**	**Practice Area (Lead)(s)**	**Financing Instrument**
ECA	March 20, 2018	MTI/TICT	Development Policy Financing
Borrower(s)	**Implementing Agency**		
Serbia	Ministry of Finance		

Proposed Development Objective(s)

The objective is to:
(A) Improve public expenditure management through strengthened public financial management and public administration reform;
(B) Improve the financial sustainability and efficiency of energy sector public enterprises; and
(C) Improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies.

Financing (in US$, Millions)

SUMMARY

Total Financing	**US$200million in EUR equivalent**

DETAILS

Source: IBRD

Decision

Following the corporate review, the decision was taken to proceed with the appraisal and negotiation of the operation.

B. Introduction and Context

Country Context

Serbia's rapid growth before the global financial crisis was fueled by capital inflows and led to significant internal and external imbalances, with fiscal deficits averaging 5.3 percent of gross domestic product (GDP) in 2009-2014, and resulting in 2015 in a record high public debt, at 76 percent of GDP. Since then, Serbia has embarked on a fiscal consolidation and structural reform program, turning deficit into a surplus (0.2 percent of GDP in 2017) and reducing public debt. Although growth has reduced poverty, constrained by several recessions, the poverty rate declined only slightly, from 24.1 percent in 2014 to 23.5 percent in 2016, with most gains more recently. Average consumption among the bottom 40 percent of the income distribution declined more than for the population average since the crisis, due to more severe losses in employment and labor income experienced by the poor. Although overall unemployment fell to 11.8 percent in 2017, informality is high and labor force participation low with 45.5 percent of the population inactive in June 2017.

Achieving higher, more stable, and equitable economic growth would require building on the success of fiscal consolidation and addressing the long-overdue structural reforms that complete plan-to-market transition and resolve the deep-seated legacy and structural issues in the economy. These include: the oversized social and state-owned enterprises (SOEs) sector that distorts prices and crowds out private firms in factor and credit markets; significant fiscal support to inefficient SOEs that burdens fiscal accounts; and low public sector efficiency and quality of public service delivery. If they are not addressed, fiscal pressures stemming from these factors could compromise the gains already achieved by fiscal consolidation and structural reforms, and hurt growth and poverty reduction in the long-run.

Relationship to CPF

The proposed DPL series contributes to the World Bank CPF FY16-20 Focus Area 1: Economic Governance and the Role of the State and its related objectives. The CPF was approved in June 2015 with the goal to support Serbia in creating a competitive and inclusive economy and, through this, to achieve integration into the EU. More specifically the CPF sets two focus areas for support: 1. Economic Governance and the Role of the State; and 2. Private Sector Growth and Economic Inclusion. This DPL series contributes to the first CPF focus area, cutting across four of the five objectives of the focus area, namely (i) supporting sustainable public expenditure management, (ii) assist in creating a more effective public administration and improving service delivery, (iii) more efficient and sustainable power utilities, and (iv) more efficient public transport companies.

C. Proposed Development Objective(s)

The proposed Public Expenditure and Public Utilities Development Policy Loan (PEPU DPL) – second in a programmatic series of two operations – supports the Government of Serbia's multi-year fiscal consolidation agenda, reforms in public administration, and transformation of energy and transport sector public enterprises and state-owned companies. The policy measures under the series are an integral part of the Government's program of critical policy and institutional reforms and support the implementation of strategic sector objectives in the context of Serbia's European Union (EU) accession process. The DPL series has three key development objectives: (A) Improve public expenditure management through strengthened public financial management and public administration reform; (B) Improve the financial sustainability and efficiency of energy sector public enterprises; and (C) Improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies.

Key Results

The proposed operation is expected to support the following results. Under Pillar A, improved transparency and data on incurred commitments and the level of arrears, as well as contribution to the implementation of a new wage system in the public sector. Under Pillar B, increased efficiency and financial sustainability of the public enterprises in the energy sector. Under Pillar C, helping public enterprises in the transport sector to improve their financial reporting, restructure debt, and increase efficiency.

D. Program Description

The Government's overall program is strategically oriented toward accelerating the EU integration process, maintaining macroeconomic stability, creating jobs, and boosting competitiveness. To accelerate EU accession, the Government is committed to speed up the implementation of economic reforms. The Government's priorities for fiscal consolidation and structural reforms are embodied in its Fiscal Strategy and its Economic Reform Program (ERP), presented to Parliament and to the European Commission (EC), respectively. An ambitious economic program is set forth that includes continued fiscal consolidation to ensure macroeconomic stability; putting debt on a downward trajectory; improving financial sector stability and resilience; and structural reforms to boost competitiveness and ensure sustainable growth. Structural reforms include: (1) steps to strengthen the business environment by ensuring greater policy and institutional predictability, better coordination of different agencies, and more efficient incentive policies; reforming the labor market to make it more flexible; reforming and streamlining of the system for issuing construction permits; and upgrading of critical transport infrastructure; and (2) structural reforms of the public sector that aim to make it more efficient, reduce the footprint of the state, and lower fiscal risks.

The PEPU DPL series is consistent with the Government' objective of making more effective use of public resources by improving delivery systems and strengthening PFM, support to increased efficiency and financial sustainability of SOEs and public enterprises, and reducing fiscal risks related to contingent liabilities. Under Pillar A, reforms have already contributed to the reduction in the level of spending on public sector wages relative to GDP. The new, systemic, "umbrella" Law on the Salary System of Public Sector Employees was also adopted in 2016 and amended in 2017, making the public employment structure more efficient and equitable. Under Pillars B and C, pivotal reforms are taking Serbia further in the transition to a well-functioning market economy and helping fulfil commitments toward EU accession. A Government priority is the finalization of commercial SOE privatization and the corporatization of large energy utilities and transport companies so that they are run on a commercial, efficient, and financially sustainable basis, as supported by this DPL series. Since the 1990s, the transition to commercially-oriented utilities in Serbia's energy and transport sectors has lagged considerably behind other countries in the region due to systemic institutional inadequacies. Energy and transport reforms aim to improve the efficiency of these public services and reform them in line with commitments toward the EU.

E. Implementation

Institutional and Implementation Arrangements

The Ministry of Finance is responsible for the overall monitoring and assessment of the implementation of the proposed reform agenda and for coordinating actions with other concerned ministries and agencies. In addition to the Ministry of Finance, Ministry of Public Administration and Local Self-Government, Ministry of Energy and Mining, and the Ministry of Construction, Transport and Infrastructure, key entities directly responsible for implementing the supported program include EPS, Srbijagas, Railways, and Roads of Serbia.

F. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

Some of the DPL prior actions may have adverse distributional and social impacts in the short run, though mitigating measures are in place and the overall poverty impact is expected to be limited. These include workforce optimization in the public administration, EPS, and public railways companies, but the overall poverty impact is expected to be limited given the income profiles of affected workers and mitigating measures such as compensation packages, programs of employment support, and labor regulations. The inflation-equivalent increase in electricity costs in 2017 is not expected to have a significant impact, while continuing the protection of vulnerable populations through the targeted Energy Vulnerable Customers Program would help address energy affordability concerns among poor and vulnerable consumers. The legislations related to the Public Sector Wage System are not expected to have significant adverse distributional impacts to the extent that the implementation includes only the re-categorization of public workers and no adverse salary adjustments.

Environmental Aspects

Overall the reform policies supported by the DPL series are not likely to have significant effects on the environment, forests and natural resources. By supporting the electricity tariff rises, which help correct distorted price signals, the operation is likely to generate environmental benefits through improved energy efficiency. Energy and carbon intensity in Serbia are high compared to the other Southeast Europe countries, given the large share of fossil fuel (particularly lignite) in their mix. Gradually adjusting the electricity prices for households and small and medium enterprises will create incentives to move toward the more efficient use of electricity, including discouraging use of electricity for heating purposes, and hence provide potential climate change mitigation co-benefits. Potential negative environmental impact of energy prices adjustments, through additional pressure on other fossil fuels such as coal and wood by vulnerable households, is assessed as negligible, given relative cost of fuels, prevailing housing conditions that are not conducive to such switch, and availability of social protection programs. Improvements in operational efficiency in railways and quality of roads are likely to result in more efficient fuel use, thus contributing to environmental sustainability.

G. Risks and Mitigation

The overall risk rating of this operation is substantial, mitigated by the EU accession process and strong commitment to reforms, supported by a range of partners. The overall rating is determined by substantial political and governance risks. These are compounded by the complexity and depth of the reform program supported by the DPL and that result in substantial implementation, social and stakeholder risks. On the other hand, macroeconomic and fiduciary risks as well as those related to sector strategies and policies and technical design are considered moderate. The risks are mitigated by the government’s overarching strategic objective of EU accession, which implies an acceleration of the structural reforms. These reforms are also supported by the World Bank and other development partners. These arrangements mitigate political, macroeconomic and capacity risks.

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