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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

DOCUMENT FOR A PROPOSED

DEVELOPMENT POLICY LOAN

IN THE AMOUNT OF EUR 182.6 MILLION
(US$200 MILLION EQUIVALENT)

TO

THE REPUBLIC OF SERBIA

FOR THE

FIRST PUBLIC EXPENDITURE AND PUBLIC UTILITIES
DEVELOPMENT POLICY LOAN

December 14, 2016

Macroeconomics and Fiscal Management and Energy and Extractives Global Practices
Europe and Central Asia Region

REPUBLIC OF SERBIA - GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of November 18, 2016)

Currency Unit	Serbian Dinar
US$1.00	116.2
EUR 1.00	123.2

ABBREVIATIONS AND ACRONYMS

CPF	Country Partnership Framework
DPL	Development Policy Loan
EC	European Commission
EPS	Serbia's national electric power utility (*Elektroprivreda Srbije*)
EU	European Union
FDI	Foreign Direct Investment
FCP	Financial Consolidation Plan
GDP	Gross Domestic Product
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
LEP	Law on Environmental Protection
MoF	Ministry of Finance
NBS	National Bank of Serbia
NES	National Employment Service
NPL	Nonperforming loan
PA	Privatization Agency
PDO	Program Development Objective
PEFA	Public Expenditure and Financial Accountability
PERS	Public Enterprise Roads of Serbia (*Putevi Srbije)*
PFM	Public Financial Management
PIFC	Public Internal Financial Control
PSIA	Poverty and Social Impact Assessment
SAI	State Audit Institution
SOE	State-Owned Enterprise
TA	Technical Assistance

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THE REPUBLIC OF SERBIA

FIRST PUBLIC EXPENDITURE AND PUBLIC UTILITIES DEVELOPMENT POLICY LOAN

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SUMMARY OF PROPOSED LOAN AND PROGRAM

THE REPUBLIC OF SERBIA

FIRST PUBLIC EXPENDITURE AND PUBLIC UTILITIES DEVELOPMENT POLICY LOAN

Borrower	The Republic of Serbia
Implementation Agency	Ministry of Finance
Financing Data	Amount: EUR 182.6 million (US$200 million equivalent). Terms: IBRD Variable Spread Loan; 20 years total repayment term, including 19.5 years of grace; bullet repayment of principal.
Operation Type	Programmatic (1st of 2), single-tranche
Pillars of the Operation And Program Development Objective(s)	This is the first in a proposed series of two development policy loans to support the Government of Serbia's multi-year fiscal consolidation agenda and transformation of energy and transport sector public enterprises and state-owned companies. The programmatic DPL series supports critical policy and institutional reforms within three pillars with the following 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.
Result Indicators	A1 - Increased percentage of invoices for public to public commercial transactions recorded in the central register: Baseline (end-2015): 0 percent; Target (end-2018): 100 percent A2 - The number of employees in the public sector, as determined by the Law on the Ceiling on Public Sector Employees, does not exceed the total of institutional-level limits set under the Law and its decisions: Baseline (end-2015): no; Target (end-2018): yes A3 - Increased share of employees within the education, health and social protection sectors paid on the basis of their new grades set out in the Public Sector Job Catalogue: Baseline (end-2015): zero; Target (end-2018): 60 percent B1 -Increased convergence of the guaranteed electricity supply tariff to reach market parity levels: Baseline (end-2014): 64 percent; Target (end-2018): 80 percent B2 - Increased number of total beneficiaries of the Energy Vulnerable Program: Baseline (2014 annual): 60,600 households; of which 27 percent female headed households; Target (2018 annual): 100,000 households; of which 30 percent female headed households B3 - Reduction in EPS annual wage bill relative to 2015: Baseline (2015): 0; Target (2018): 10 percent B4 - Increase in Srbijagas' collection rate of current receivables: Baseline (2015): 80 percent; Target (average 2016-2018): 87 percent B5 - The approved Srbijagas 10-year development plan for the Gas Transport System Operator and 5-year development plan for the Distribution System Operator are in accordance with the adopted economic and financial appraisal methodology: Baseline (2016): No; Target (2018): Yes C1 - Level of annual direct budget operational support to the Railways Companies: Baseline (2015): RSD 13.5 billion; Target (2018): RSD 11 billion C2 - Improvements in labor productivity (measured by train kilometers per employee) and in asset utilization (measured by passengers per kilometer of track and ton per kilometer of track) relative to 2015: Baseline (2015): zero; Target (2018): 15 percent (for both indicators) C3 - Reduction in annual wage bill of railways companies relative to 2015: Baseline (2015): zero; Target (2018): 25 percent C4 - The government agrees with Roads of Serbia on maintenance levels for the different road classes with associated guaranteed funding levels committed: Baseline (for 2016 budget): no; Target (for 2019 budget): yes
Overall risk rating	Substantial
Operation ID	P155694

IBRD PROGRAM DOCUMENT FOR A PROPOSED FIRST PUBLIC EXPENDITURE AND PUBLIC UTILITIES DEVELOPMENT POLICY LOAN TO THE REPUBLIC OF SERBIA

I. INTRODUCTION AND COUNTRY CONTEXT (INCLUDING POVERTY DEVELOPMENTS)

1. **This program document presents a proposed Public Expenditure and Public Utilities Development Policy Loan (DPL) – the first in a programmatic series of two operations – to support the Government of Serbia's multi-year fiscal consolidation agenda and transformation of energy and transport sector public enterprises and state-owned companies**. The measures supported under the proposed series are an integral part of the Government of Serbia's ambitious 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. The DPL series is central to the World Bank Group Country Partnership Framework (CPF) FY16–20 Focus Area 1: Economic governance and the role of the state, and complementary to related operations and technical assistance (TA).

2. **The global financial crisis resulted in a deterioration of living conditions in Serbia, although poverty has since slowly receded.** As a result of the global financial crisis, poverty peaked at 15.1 percent in 2010 using the US$5/day poverty line (2005 PPP) and then declined to 14.5 percent in 2013, the latest year for which comparable data is available. Relative poverty, or the fraction of population living below 60 percent of the median income, was estimated at 25.4 percent in 2015 and inequality at 28.2 Gini points.[1] Since the crisis, average consumption among the bottom 40 percent of the income distribution declined more than for the population average, due to more severe losses in employment and labor income experienced by the poor. Labor market outcomes have improved slightly in recent years, though unemployment remains high at 15.2 percent in the second quarter of 2016, and the employment rate is low at 45.9 percent of the population above 15 years of age.

3. **Structural and fiscal reforms are helping Serbia's growth to recover after the 2008 global crisis exposed structural weaknesses in the economy.** The 2008 crisis and the subsequent economic downturn in Serbia highlighted the need for fiscal consolidation and acceleration of the unfinished transition to a market economy.[2] Serbia's rapid growth during 2001–08, driven by domestic demand and fueled by capital inflows, led to significant, and unsustainable, internal and external imbalances. As a result, in 2008, government spending was almost 45 percent of gross domestic product (GDP) with a sizeable state-owned and public enterprise presence adding to the state's economic footprint. Between 2009 and 2015, public debt doubled to 76 percent of GDP. At the same time, the stock of public guarantees, mainly to SOEs and public enterprises, rose from below 3 percent of GDP in 2008 to 7.2 percent at end-2015. However, in stepping up structural and fiscal reforms, the government's actions, complemented by improved external conditions, have supported a recovery, with growth of 2.7 percent projected for 2016.

[1] In 2012, Serbia adopted the EU relative poverty measure—the fraction of the population living below 60 percent of the median income—as its official poverty rate. This indicator is based on the 2015 EU-SILC survey for Serbia.
[2] For further analysis see World Bank (2015), Serbia Systematic Country Diagnostic.

4. **The government's economic program, as set out in its Fiscal Strategy for 2016-18, focuses on fiscal consolidation to ensure macroeconomic stability, improving financial sector stability and resilience, boosting competitiveness, and ensuring sustainable growth.** Notwithstanding stronger-than-expected fiscal performance in 2015 and in 2016-to-date, the public financial management (PFM) and public administration reforms need to continue to ensure fiscal sustainability. Improving the financial sustainability and efficiency of energy and transport public enterprises and state-owned companies is also critical to reduce direct and indirect government support to these sectors, which weighs heavily on the budget. Successful implementation of reforms in public administration, energy, and transport sectors will improve public service delivery and economic efficiency and create foundations for faster medium-term growth and private-sector led job creation.

5. **The combination of economic pressures, an improvement in relations with Serbia's neighbors and domestic reform momentum, have provided an important opportunity to accelerate reforms**. Following elections in March 2014, a government with a strong majority was formed, giving Serbia a new opportunity to overcome past fragmentation and build momentum for reform. The coalition of the Prime Minister subsequently won early Parliamentary elections held in April 2016, with a new government formed in August 2016. The government is committed to focus on transforming the state administration, public finances, and the economy, along with pursuing the EU accession process.

6. **The proposed DPL will support implementation of challenging reforms that are critical to the government's fiscal consolidation and structural reform agenda**. The operation has a substantial risk, but could bring high reward. Risks to the operation include political, social and stakeholder risks related to sensitive measures such as labor rightsizing in public administration, electricity and rail companies, and electricity tariff increases for residential consumers. Substantial progress has been achieved in the implementation of key reforms to date, for example, in relation to fiscal consolidation and restructuring of electricity and rail companies, confirming their high priority for the government, with the recovery in growth showing to the public the potential pay-offs to reform progress. Other mitigating factors are the high-level and implementation support to these reforms from the three-year precautionary International Monetary Fund (IMF) Stand-By-Arrangement (SBA) as well as related World Bank activities. These include TA in energy and transport as well as reforms supported by the state-owned enterprise (SOE) Reform DPL series, which focuses on commercial SOEs as well as the governance framework for SOEs and measures to limit the social impact of SOE reform, and operations in support of public administration reform, and job creation and employment support (see Section 4.3). The ongoing EU accession process is also a fundamental anchor for the Government's reforms.

II. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

7. **Serbia's recent economic performance has been positive, as growth recovers from the three recessions experienced over 2009 to 2014.** After average annual growth of 5.9 percent during the decade before the 2008 global financial crisis, the economy contracted by 3.1 percent in 2009. After a timid recovery in 2010 and 2011, it fell back into recession in 2012 and 2014 (primarily due to a drought and severe floods respectively). In response to the slowdown and a sharp rise in public debt, government reforms have focused on fiscal consolidation and structural measures to restore a sustainable growth path and address external and fiscal imbalances. Supported by the recovery of

industrial production following the 2014 floods, positive growth returned in 2015 (at 0.8 percent). Industry was the primary driver, with real value added up 4.3 percent y/y in 2015 while agriculture value added fell 7.7 percent, hit by a summer drought. The recovery continued in 2016, with strong y/y growth of 3.5 percent in Q1, 2.0 percent in Q2 and 2.5 percent in Q3, according to flash estimates.

8. **Investment and exports have supported the recovery in growth.** Unlike in 2014, when all components of GDP had a negative contribution to growth, investment and exports increased significantly in 2015 (up 7.7 and 10.2 percent in real terms y/y, respectively), aided by the recovery from the floods and improved external demand. However, consumption has been under pressure from cuts in public sector wages and pensions and increased by a mere 0.1 percent y/y in 2015. In early 2016, a pick-up in growth was seen, reaching 3.8 percent y/y in Q1. Net exports contributed 2.5 percentage points to this growth but in Q2 posted a negative contribution due to a strong growth of imports, in part because export-oriented business still have a high import component. This offset a significant positive contribution of consumption and investment (1.8 and 2.7 percentage points, respectively) resulting in a moderation in overall growth in Q2 to 2 percent y/y. Within investment, increased public investment offset some slowing in private investment growth, as foreign direct investment (FDI) declined, and the growth of capital goods imports and loans to enterprises slowed, perhaps reflecting uncertainty around the election.

9. **Improved export performance has supported Serbia's external adjustment following the crisis, with the current account deficit falling from 11.5 percent of GDP in 2012 to 4.7 percent in 2015.** Since 2010, and in particular in 2013 when the carmaker FIAT started production in Serbia, exports have been a significant driver of growth and narrowing of the trade deficit. Following the 2014 floods, export values (in euro) recovered to grow by 7.8 percent in 2015, and were up 10.1 percent y/y in the first nine months of 2016. The fall in the merchandise trade deficit supported a narrowing of the current account deficit, particularly in 2013, although an improved service balance and net transfers were the main drivers of the narrowing in 2015. The current account deficit continued to decline in 2016, mainly again due to a lower trade deficit. In the financial account, FDI has been on a positive trend until 2016, moving from 2.1 percent of GDP in 2012 to 5.5 percent in 2015, more than covering the current account.

10. **The recent recovery in economic activity has been reflected in improved labor market outcomes.** High unemployment is a longstanding issue in Serbia. The unemployment rate reached a peak of 24 percent in 2012 but has declined since. Results from 2015 were particularly encouraging, with the annual unemployment rate falling to 17.7 percent, and then to 15.2 percent in Q2 2016, as growth recovered. Overall real wages fell again in 2015, down 2 percent y/y, following declines of 1.5 and 0.8 percent over 2013 and 2014 respectively. The wage cut and freeze in the public sector, as discussed below, was a key driver of these trends. Overall wages increased in the first half of 2016 by 4.2 percent y/y in nominal or 3.2 percent in real terms. Over the same period, public sector wages increased by 1.8 percent y/y as limits on wages adjustment were partially lifted, while private wages rose by 5.7 percent.

11. **Despite monetary policy easing, inflation continues to undershoot the inflation target band of the National Bank of Serbia (NBS).** Low energy and food prices, and still relatively weak domestic demand, contributed to average consumer price inflation of 1.9 percent in 2015, below the current NBS target band of 4±1.5 percent. Over the first nine months of 2016, inflation averaged 1 percent y/y. Faced with low inflation, NBS has lowered its key policy rate since May 2013, and announced a lowering of the inflation target (as discussed below). The latest rate cut was in July 2016 (to 4

percent). The NBS's inflation targeting framework and commitment to maintain a flexible exchange rate appear appropriate, although high levels of euroization limit the monetary transmission mechanism.

12. **While falling against a strengthening US dollar, the Serbian dinar has been relatively stable against the Euro.** The current account improvement in 2015 supported the exchange rate against the Euro. But – in line with other emerging economy currencies – the dinar depreciated significantly against the US$ in 2015 (with the annual average exchange rate down 11.8 percent y/y), particularly earlier in the year. In early 2016 the dinar depreciated slightly against the euro, but it has remained stable since. NBS continues to intervene regularly to prevent more significant fluctuations in the exchange rate against the euro. The average real effective exchange rate depreciated by 5 percent in 2015 relative to 2014 and as of September 2016 was down a further 1.5 percent on its 2015 average level.

Table 1. Key Macroeconomic Indicators and Projections

	2012	**2013**	**2014**	**2015e**	**2016p**	**2017p**	**2018p**	**2019p**
Real Economy	Annual percentage change, unless otherwise indicated							
GDP (nominal, RSD)	5.2	8.2	0.8	3.5	4.0	4.6	6.4	6.6
Real GDP	-1.0	2.6	-1.8	0.8	2.7	3.0	3.5	3.5
Contributions:								
Consumption	-1.2	-0.6	-1.1	0.1	1.2	1.3	2.0	2.5
Investment	0.6	-1.5	-0.1	1.5	0.8	1.2	1.2	1.0
Net Exports	-0.4	4.8	-0.6	-0.8	0.6	0.5	0.3	0.0
Exports	0.3	7.4	2.3	4.5	4.5	4.0	4.1	4.2
Imports	0.7	2.6	3.0	5.4	3.8	3.4	3.9	4.32
Unemployment rate (average, ILO definition)	24.0	22.1	19.2	17.7	17.7	16.9	16.0	15.5
GDP deflator	6.3	5.4	2.7	2.7	1.3	1.6	2.8	3.0
CPI (eop)	12.2	2.2	1.7	2.1	1.5	2.8	3.0	3.0
Fiscal Accounts	Percent of GDP							
Expenditures	46.6	43.5	46.3	44.0	43.9	42.6	42.0	41.4
Revenues	39.4	37.9	39.7	40.4	41.7	40.9	40.7	40.4
General Government Balance	-7.2	-5.6	-6.6	-3.7	-2.1	-1.7	-1.3	-1.0
Public and Publicly Guaranteed Debt (eop)[a]	57.4	60.9	71.8	75.9	73.7	72.4	70.4	67.4
Selected Monetary Accounts	Annual percentage change, unless otherwise indicated							
Base Money	5.2	25.9	10.9	17.1	..	..	..	..
Credit to non-government	9.8	-4.5	6.1	2.0	..	..	..	..
Interest (key policy interest rate)	11.3	9.5	8.0	4.5	..	..	..	..
Balance of Payments	Percent of GDP, unless otherwise indicated							
Current Account Balance	-11.5	-6.1	-6.0	-4.7	-4.2	-3.9	-3.9	-3.9
Exports	26.5	30.8	31.9	33.9	35.9	37.9	39.1	40.1
Imports	44.2	42.9	44.3	45.8	46.5	48.5	49.4	50.1
FDI	2.1	3.6	3.7	5.4	5.2	4.8	4.3	4.2
Gross Reserves (in EUR bill, eop)	10.9	11.2	9.9	10.4	..	..	..	..
In months of next year's imports	7.4	7.4	6.3	6.4	..	..	..	..
In percent of short-term external debt	209	279	292	281	..	..	..	..
Terms of Trade	-0.9	1.0	0.8	1.5	..	..	..	..
Exchange Rate (EUR, average)	113	113	117	121	..	..	..	..

	2012	2013	2014	2015e	2016p	2017p	2018p	2019p
Other memo items								
GDP nominal in EUR billion	31.6	34.3	33.3	33.5	34.2	35.2	37.4	39.3

Notes: [a] World Bank projections. Includes non-guaranteed debt of local governments.
Source: Ministry of Finance (MoF); World Bank estimates IMF; NBS.

13. **The financial system is broadly stable, although weaknesses remain in some state-owned banks.** The Serbian financial system weathered the global financial crisis and successive recessions relatively well, but a weak domestic economy resulted in a substantial increase in nonperforming loans (NPLs) and reduction in profitability. NPLs stood at 19.6 percent as of August 2016. While banks remains well-capitalized and liquid, additional challenges emerged related to the situation in Greece, since four Greek banks are operating in Serbia (accounting for about 11 percent of total assets in Q2 2016). The NBS has undertaken steps to prevent any shocks in these, and other commercial banks, through intensified oversight. In addition, the NBS is actively working on the resolution of the longstanding problem of non-performing loans under the new Action Plan for NPLs resolution (approved in August 2015). NPLs declined by 2 percentage points over the first eight months of 2016.

14. **The recovery in credit growth has continued in 2016.** Total loans were up 12.7 percent in September 2016 (y/y) mainly because of a significant increase of banks' lending to the government sector. Household loans were up 10.4 percent while those to enterprises (both private and public) were 2.9 percent higher y/y, in line with the recovery in investment, as well as lower interest rates. This includes a return to positive growth for loans to private enterprises (up 7 percent y/y in September).

15. **The government's consolidation program, put in place in 2014, has contributed to a significant improvement in fiscal performance.** The general government deficit in 2015 was 3.7 percent of GDP, down from 6.6 percent in 2014, primarily as a result of increased revenues (up 4.6 percent y/y in nominal terms). However, this was mainly supported by a major increase in non-tax revenues reflecting one-off measures (for example, payment of net income from SOEs and the sale of 4G licenses). Nominal government expenditures declined by 1.9 percent as a result of major savings on wages and pension (down by 8.4 and 3.5 percent, respectively). Solid budget performance has continued in 2016. Revenues were up 9.3 percent y/y though September 2016, although in this case the main driver was better collection of excises and value-added tax. Expenditures rose by 5.3 percent, driven by purchases of goods and services and capital expenditures (up 10 and 35 percent, respectively). The general government deficit in through September 2016 was just one tenth of its value in the same period of 2015 and is projected to be 2.1 percent of GDP for 2016 as a whole (down from a previously-projected 4 percent).

16. **As a result, general government debt (including guarantees) has started to fall in 2016, after having reached 75.9 percent of GDP at end-2015.** Although the deficit narrowed, government debt as a share of GDP increased in 2015 by almost 4 percentage points, partially due to the strengthening US dollar (with 33 percent of debt dollar-denominated). With repayments exceeding new borrowing, government debt decreased by €663 million over the first nine months of 2016 to reach 73.5 percent of GDP. Given the marked rise in the stock of debt, much of which was acquired at a time of relatively high interest rates, interest payments are a growing fiscal burden (7.5 percent of projected 2016 spending or 3.3 percent of GDP). Current financing conditions for Serbia are though favorable due to strong global demand for emerging market debt and the country's own stronger macro-fiscal fundamentals. As a result, Serbian government global bonds trade at spreads that were until recently

more associated with investment grade credit (Serbia is current rated 3 to 4 notches below investment grade).

17. **Reinforcing the importance of reforms supported by this operation, public guarantees take up a large part of debt (8.7 percent of total debt at end-September 2016), with 85 percent of the guarantees for public enterprises (particularly Srbijagas) and SOEs**. A relatively large share of this high cost state guaranteed debt was contracted over the past few years when market conditions were more expensive. The amortization and interest payments on activated guarantees is projected at just under 2 percent of total government spending in 2016, or around 5 percent of total debt service costs.

2.2 MACROECONOMIC OUTLOOK, DEBT SUSTAINABILITY

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

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

Table 2. Balance of payments financing requirements and sources

(In percent of GDP)	2015	2016	2017	2018	2019
Gross external financing requirements	**13.1**	**10.8**	**15.1**	**16.6**	**16.5**
Current account deficit	4.7	4.2	3.9	3.8	4.0
Debt amortization	7.0	9.7	11.2	12.5	11.7
Change in gross reserves (increase=+)	1.4	-3.1	0.0	0.3	0.8
Gross external financing sources	**13.1**	**10.8**	**15.1**	**16.6**	**16.5**
FDI and portfolio investments (net)	4.5	5.3	4.8	4.8	5.9
Official capital grants	0.0	0.0	0.0	0.0	
Debt disbursements	8.1	8.2	11.2	10.7	9.7
Other net capital inflows	0.4	-2.6	-0.8	1.1	0.8

Source: IMF; NBS.

20. **Inflation is set to remain subdued in 2016 and then pick up gradually as domestic demand recovers.** As domestic demand picks up, inflation is projected to rise, returning to the NBS target band in 2017. Monetary policy will continue to be implemented through an inflation targeting framework combined with a flexible exchange rate (with any intervention focusing on managing excess currency

volatility). In November 2016, NBS announced that the inflation target for 2017 through end-2018 would be 3±1.5 percent, a lowering of the target mid-point by one percentage points due to improved macro fundamentals and reduced macro imbalances, as well as softer inflation expectations of the corporate and financial sectors.

21. **Implementation of the Government's ambitious fiscal consolidation and structural reforms program will support a continuation of the downward trajectory of the public debt ratio.** As mentioned, the fiscal consolidation program, supported by the IMF SBA, focuses on reducing public sector wage bills and pension costs, along with a reduction in fiscal support to public enterprises, in conjunction with broad-ranging structural reforms. In 2016, further fiscal adjustment is targeted beyond the already significant achievement in 2015. The approved 2016 budget aimed to keep the general government deficit at a similar level to 2015 (around 4 percent of GDP), but results from the year-to-date suggest that annual deficit will be most likely be just above 2.1 percent of GDP. The draft Budget for 2017 is based on a conservative projection of revenues (to drop by 0.8 percentage points of GDP compared to 2016) but, based on a fall in expenditures, the deficit is expected to narrow further to 1.7 percent of GDP. Budgetary savings are expected to come primarily from lower subsidies in 2017, as there will be a partial increase in public sector wages and pensions. Over the medium term, the deficit is projected to fall to around 1-1.5 percent of GDP with spending declining from 43.9 percent in 2016 to 41.4 percent of GDP by 2010, mostly through cutting recurrent spending (wages and pensions) and amortization costs on activated guarantees. The revenue-to-GDP ratio is set to decline gradually (from 41.7 percent of GDP in 2016 to 40.4 percent in 2019), with exports and investments, the main drivers of growth, not seen as helping revenues (for example, value-added tax) significantly.

22. **Under the baseline scenario, public debt-to-GDP is projected to fall from a peak of 75.9 percent at end-2015 to under 68 percent by 2019.** Assuming the fiscal consolidation strategy is implemented as planned through completion of the IMF program in 2018, the primary balance is projected to improve from a deficit of 3.7 percent of GDP in 2014 to a 2 percent surplus in 2019. However, given the high initial level of debt, even with this fiscal consolidation, public debt-to-GDP will remain high over the projection period, declining below 70 percent only by 2019. The government's gross fiscal financing needs also remain significant at 16 percent of GDP in 2017. From 2016 and 2017, external debt amortizations are projected to rise from 2 percent to 5 percent of GDP, with the maturing in 2017 of a 5-year US$750 million dollar-denominated Eurobond and a EUR 293 million commercial loan.

23. **The projected public debt path is highly sensitive to any slippages in the fiscal consolidation plan, weaker-than-expected growth or to a negative real exchange rate shock**. In terms of the debt profile, only around 21 percent of central government debt is variable interest rate, with 79 percent fixed. Most public debt is external direct debt (43.6 percent of GDP) while domestic public debt accounts for 29.1 percent of GDP as of end-September 2016. Foreign-currency debt is high, with 41 percent in euro and 33 percent in US dollars versus 21 percent denominated in local currency. As a result, a sharp real depreciation would move the debt ratio up markedly. Both slippages in fiscal consolidation progress and lower-than-anticipated growth could also lead to the debt ratio rising again.

24. **The MoF is taking steps to reduce financing costs and the fiscal risks associated with the size and structure of its debt.** Taking advantage of current market conditions, it aims to reduce its financing costs through restructuring or refinancing of existing high-cost liabilities, to rebalance the

currency composition to lower currency risks, and to smooth the future amortization profile, thereby lowering refinancing risks.

25. **The macroeconomic policy framework is considered** adequate **for the proposed operation.** The authorities are committed to adjust fiscal policy as needed to maintain debt sustainability over the medium term while supporting growth through structural reform progress. The macro-fiscal framework is supported by the precautionary IMF program. There are though substantial downside risks to the macroeconomic framework, both external and internal. External risks relate to a lower-than-expected EU recovery would impact Serbia through exports, remittances and capital flows. Higher volatility in international financial markets could also pose risks to the outlook through financial channels given Serbia's refinancing needs and foreign currency debt burden, and also via real channels through their potential spill over to external demand. A deterioration of the financial situation of foreign parent banks could similarly jeopardize credit recovery and undermine growth. Key domestic risks arise from the implementation of the fiscal reform program. If some of these risks, were to materialize the government would need to undertake even greater fiscal consolidation efforts to ensure that public debt remains sustainable. To mitigate these risks, the government is working, including with EU and international financial institution (IFI) partners, to ensure that key reforms (for example, on public administration, SOEs and public enterprises) remain on track.

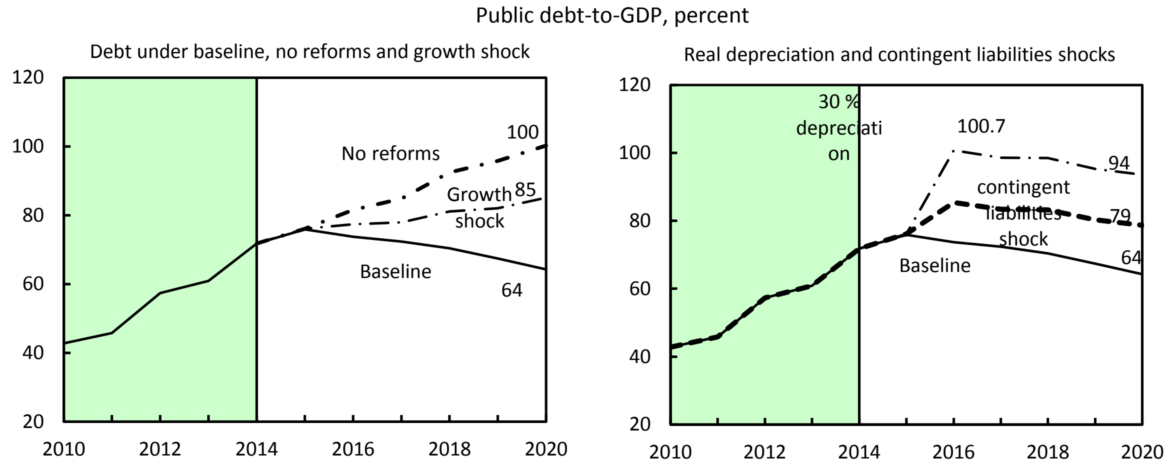
Table 3. Consolidated General Government Fiscal Operations

(In percent of GDP)	2012	2013	2014	2015e	2016p	2017p	2018p	2019p
Revenue	**39.4**	**37.9**	**39.7**	**40.4**	**41.7**	**40.9**	**40.7**	**40.4**
Taxes	34.2	33.4	35.0	34.6	35.9	35.8	35.8	35.7
Personal income tax	4.6	4.0	3.7	3.6	3.7	3.7	3.7	3.7
Social security contributions	10.6	10.8	11.3	11.0	11.0	11.1	11.2	11.3
Corporate income tax	1.5	1.6	1.9	1.6	1.9	1.8	1.8	1.8
Value-added taxes	10.3	9.8	10.5	10.3	10.6	10.6	10.6	10.6
Excises	5.1	5.3	5.4	5.8	6.3	6.2	6.1	6.0
Taxes on international trade	1.0	0.8	0.8	0.8	0.9	0.9	0.9	0.9
Other taxes	1.2	1.1	1.5	1.6	1.6	1.5	1.5	1.4
Non-tax revenue	5.0	4.2	4.4	5.5	5.4	4.8	4.7	4.5
Capital revenue	0.0	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Grants	0.1	0.1	0.2	0.2	0.3	0.3	0.2	0.2
Expenditure	**46.6**	**43.5**	**46.3**	**44.0**	**43.9**	**42.6**	**42.0**	**41.4**
Current expenditure	42.5	40.8	42.7	40.4	39.8	38.5	38.0	37.5
Wages and salaries	10.5	10.1	9.9	8.8	8.5	8.4	8.3	8.1
Goods and services	8.0	7.2	7.9	7.5	8.0	7.8	7.9	7.8
Interest	1.9	2.4	2.9	3.2	3.3	3.2	3.1	3.0
Subsidies	4.1	3.3	4.0	3.3	2.9	2.5	2.5	2.5
Transfers	18.1	17.7	17.8	17.6	17.0	16.5	16.3	16.1
Pensions	13.2	12.8	13.0	12.1	12.0	11.6	11.4	11.2
Other transfers	4.8	4.9	4.8	5.4	5.0	4.9	4.9	4.8
Capital expenditure	3.3	2.1	2.5	2.9	3.1	3.2	3.4	3.4
Net lending	0.5	0.3	0.4	0.1	0.1	0.1	0.1	0.1
Amortization of activated guarantees	0.3	0.2	0.8	0.7	0.9	0.8	0.4	0.4
Fiscal balance (incl.	**-7.2**	**-5.6**	**-6.6**	**-3.7**	**-2.1**	**-1.7**	**-1.3**	**-1.0**

(In percent of GDP)	2012	2013	2014	2015e	2016p	2017p	2018p	2019p
amortization of called guarantees)								
Primary fiscal balance	-5.3	-3.2	-3.7	-0.5	1.2	1.4	1.8	2.0

Source: IMF; MoF, World Bank staff estimates.

Figure 1. Serbia: Public Debt Sustainability[1,2]



Note: [1] Shaded areas represent actual data. Individual shocks (growth, primary balance) are permanent ½ standard deviation shocks from historical 10-year averages from 2015. [2] One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2015, with real depreciation defined as nominal depreciation against US dollar minus domestic inflation (based on GDP deflator).
Source: Serbia MoF, IMF, World Bank staff projections.

2.3 IMF RELATIONS

26. **The Executive Board of the IMF approved a three-year, SDR 935.4 million (about €1.2 billion, 200 percent of quota) Stand-By Arrangement for Serbia on February 23, 2015, and on December 16, 2016 approved the sixth program review.** The program is based on three pillars: restoring health of public finances; increasing the stability and resilience of the financial sector; and implementing comprehensive structural reforms, to form a solid foundation for job creation and return to sustained high growth. The World Bank, IMF and government have worked in close cooperation, for example, with the World Bank working collaboratively in providing upstream inputs on public administration reform and public enterprise restructuring and helping the government develop a clear, time-bound restructuring plan for public enterprises and to complete functional reviews of certain line ministries. The recent Fund 6th review mission (October-November 2016) highlighted the need to end the fiscal burden of large utility companies and other SOEs, in particular the discontinuation of the financing of weak public entities and companies through arrears to Srbijagas and Serbia's national electric power utility (*Elektroprivreda Srbije* EPS).[3]

[3] http://www.imf.org/en/News/Articles/2016/11/01/pr16476-IMF-Staff-Completes-Review-Mission-to-Serbia.

III. THE GOVERNMENT'S PROGRAM

27. **The government's overall program is strategically oriented toward accelerating the EU integration process, maintaining macroeconomic stability, creating jobs, and boosting competitiveness.**[4] EU accession falls within the first of the ten priorities of the new government's program and, to accelerate this process, 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.[5]

28. **To achieve these objectives, 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 are organized in two broad sets. The first set focuses on reforming the real sector and includes critical 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. The second set focuses on structural reforms of the public sector that aim to make it more efficient, reduce the footprint of the state, and lower fiscal risks.

29. **Achieving a more effective use of public resources by improving delivery systems and strengthening PFM is the focus of the first area of public sector reforms.**[6] Important milestones in public administration reform have been achieved including a hiring freeze, enactment of legislation establishing the registry of public employees and the ceiling on their number, to support monitoring and control of staffing, and freezing of wage indexation. These reforms have already contributed to the reduction in the level of spending on public sector wages relative to GDP. As discussed below, the new, systemic, Law on the Salary System of Public Sector Employees was also adopted just before the spring 2016 elections.

30. **Returning SOEs and public enterprises to financial sustainability, and reducing fiscal risks related to contingent liabilities, is the second area of public sector structural reforms.** These pivotal reforms are taking Serbia further on 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, as supported by the SOE Reform DPLs, and the corporatization of large energy utilities and transport companies so that they are run on a commercial and financially sustainable basis, as supported by this operation. Since the 1990s, the transition to commercially-oriented utilities in Serbia's energy and transport sectors has lagged considerably other countries in the region due to

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[4] Serbia obtained the candidate status for membership in the EU on March 1, 2012 and in June 2013 the European Council endorsed the Commission's recommendation to open accession negotiations. The formal start of Serbia's accession negotiations was in January 2014 and the first chapters were opened in December 2015.

[5] The Fiscal Strategy serves as an overview of ongoing and planned structural reforms and as a tool for budget planning. The ERP's main purpose is to identify reforms for advancing the EU accession process. Both documents are updated annually. For the 2016–2018 ERP and Fiscal Strategy documents see http://www.mfin.gov.rs/UserFiles/File/dokumenti/2016/ERP-2016_en.pdf and http://www.mfin.gov.rs/UserFiles/File/dokumenti/2016/FS%20za%202016%20EN.pdf respectively.

[6] Reform of public finances is one of the five main objectives in the broader Public Administration Reform Strategy, and the focus of the PFM Reform Program which was adopted in late 2015.

systemic institutional weakness and strong vested interests. Energy and transport reforms aim to improve the efficiency of these public services and reform them in line with commitments toward the EU.

31. **Going forward, the challenge will be the implementation of these ambitious reform programs**. While there has been strong political support in recent years to tackle these issues, such as advancing SOE and public enterprise reform and fiscal consolidation, the challenge going forward will be the implementation of these measures defined in the government's reform programs. The proposed operation aims at supporting the government in this endeavor to realize the benefits of increased economic efficiency and job creation in the medium term.

IV. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

32. **The proposed DPL series supports the Government of Serbia's multi-year fiscal consolidation agenda and transformation of energy and transport sector public enterprises and state-owned companies.** In particular, the proposed DPL series supports three key areas of reform:

- Pillar A: Improve public expenditure management through strengthened public financial management and public administration reform.
- Pillar B: Improve the financial sustainability and efficiency of energy sector public enterprises.
- Pillar C: Improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies.

33. **The design of the operation reflects the lessons learned from previous DPL operations in Serbia and energy and transport sector reform programs**.[7] The programmatic series consists of two DPLs including reform measures supported by the highest levels of government, with prior actions and triggers sequenced to achieve the targeted results. A key lesson for the DPL is that it should be complemented with other World Bank instruments. Ongoing implementation support in the DPL reform areas is provided through TA with the DPL series complementing the SOE Reform DPLs focusing on commercial SOEs and the Program-for-Results (PforR) operation on Modernization and Optimization of Public Administration.[8] Finally, the need to address policies or programs aimed at mitigating the adverse social impacts potentially caused by the transition is another important lesson of earlier SOE restructuring efforts in Serbia and elsewhere (see Poverty and Social Impact Assessment [PSIA] discussion below).

[7] See, for example, the 2011 Second Programmatic Public Expenditure DPL on lessons learned from DPL lending in Serbia since 2000 and the overarching lessons learned from the FY12–FY15 Serbia CPS Completion and Learning Report.

[8] See, World Bank. 2016. *Serbia - Program on modernization and optimization of public administration: program for results – environmental and social systems assessment*. Washington, D.C.: World Bank Group. The PforR operation was signed on April 20, 2016, and as of November 1, 2016, was awaiting Parliamentary ratification before being declared effective.

34. **The design of the operation involves complementary and prioritized reforms.** For example, cross-cutting measures in Pillar A on payment discipline support the objectives of the energy and transport pillars. The design of the DPL was informed by a prioritization of reforms based on their (a) impact on fiscal consolidation,[9] (b) the level of government support and feasibility within the envisaged time frame, (c) the scope to leverage the DPL series to support sustained implementation progress, and (d) the strength of the supporting evidence base and ongoing engagement and dialogue.

35. **Policy actions in public administration, energy, and transport also support the implementation of strategic sector objectives in the context of Serbia's EU accession process. Public** Energy and transport reforms are important vehicles to accelerate EU integration. The new Energy Law (2014) aligns the legislative framework with the EU's third energy package and paves the way for the integration with the EU internal energy market.[10] In transport, the 2008–2015 transport strategy for railway, road, inland waterway, air and intermodal transport, the 2011 Road on Public Roads, the 2013 Railway Law, and the Railway safety interoperability Law set targets in line with the EU legal and regulatory frameworks. In 2016, Serbia opened negotiations with the EC on chapters 14 and 21 on transport policy and Trans-European networks, respectively. Policy actions supported under the DPL tackle areas such as electricity pricing reform and railways financing policy which are critical to advance the implementation of the EU framework for the creation of competitive railway and electricity markets. Similarly, measures relating to PFM and public administration also support the high priority objective of the government of aligning the public administration with the principles of the European Administrative Space.

4.2 PRIOR ACTIONS, RESULTS, AND ANALYTICAL UNDERPINNINGS

PILLAR A: PUBLIC EXPENDITURE MANAGEMENT

Strengthened PFM

36. **PFM reform is one of the government's key priorities, with a comprehensive PFM Reform Program for 2016–2020 adopted in late 2015**.[11] This program was informed by the 2015 Public Expenditure and Financial Accountability (PEFA) assessment, as well as an Organization for Economic Cooperation and Development/Sigma assessment, and supported by the EU, World Bank, and several bilateral donors, GIZ and the Swiss Agency for Development and Cooperation, in particular. Weaknesses in ex-ante commitment control, particularly relating to multi-annual contracts, monitoring of fiscal risks associated with arrears and state and public enterprises, and budget preparation have impacted aggregate fiscal discipline and the quality of resource allocation and service delivery. Weaknesses in the planning, implementation and monitoring of public investment projects have also played a role prompting reform actions.[12] These challenges affect not only the

[9] Based, for example, on analysis in World Bank (2015), Serbia Public Finance Review.
[10] Specifically, it introduces full unbundling of the electricity and gas transport and distribution sectors, fully opens the market for competition, advances deregulation of energy prices, and enhances the independence of the national regulatory authority.
[11] See www.mfin.gov.rs/UserFiles/File/dokumenti/2016/Public%20Financial%20Management%20Reform%20Program%202016-2010%20EN.PDF .
[12] The legislative and regulatory frameworks for public investment management (PIM) are envisaged to be strengthened by the end of 2016 through adopting a by-law intended to regulate PIM, as well as a set of guidelines

aggregate fiscal performance but the efficiency and financial sustainability of large public enterprises and SOEs, including those in energy and transport sectors which are the focus of Pillars B and C of the DPL series.

37. **The PFM-related actions under the DPL series aim to support improvements in recording and control of commitments and arrears**. Measures have been taken to better manage arrears but the level of information and its quality remain a challenge.[13] The Law on Deadlines for Payments in Commercial Transactions adopted in 2013 set a maximum period for settlement of payment by a public sector entity to a private sector creditor, before interest could be charged. Complementing this measure, revisions to the Budget System Law from 2013 targeted improvements in commitment control and prevention of the creation and accumulation of expenditure arrears.[14] Nevertheless, although the MoF's Macro-Fiscal Analysis Department and the Treasury collect data on arrears from most public entities, the data is not comprehensive, and concerns remain about its reliability as no mechanism of systematic monitoring or control framework exists.[15] Despite a reported decrease in arrears in the past two years, certain sectors continue to struggle with significant arrears, and some, such as health, have actually registered an additional increase over the same period.

38. **In an important development, amendments to the Law on Deadlines for Payments in Commercial Transactions ("RINO Law") were passed in July 2015 to capture transactions between public entities.** As discussed, public-public arrears are a sizeable impediment to the financial sustainability of certain public enterprises, such as *Srbijagas*. Supervision authority over implementation of the law was also changed to the Budget Inspection unit within the MoF for transactions between public entities and public to private entities, while the Tax Administration is assigned supervision over transactions between private entities. Prior Action #1 supports implementation of the amended Law through the adoption of the monitoring framework.[16] This defines more closely the supervision arrangements and the communication of information between the Treasury, which collects information on payments, and entities in charge of supervision. The full positive impact of the RINO Law and accompanying by-laws is though subject to further constraints, such as unconfirmed accuracy and completeness of reported data by public sector entities. This issue is expected to be partly addressed by improved reporting discipline as the implementation period is longer and as the sanctions and on-site visits of the Budget Inspection—which are currently limited—are applied to a larger number of entities.[17]

39. **Further measures are needed to improve the recording and transparency of the level of arrears and the data and control over commitments.** Indicative Trigger #1 for the second DPL,

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for more efficient and effective management of public investment going forward. In addition, the Ministry of Finance is planning to implement a PIM Information System to support the various phases of PIM and improve the overview of the project portfolio.

[13] See, MoF, PFM Reform Program 2016–2020, November 2015.

[14] This primarily relates to the introduction of the software for commitments control (RINO, standing for "Registry of Settlement of Pecuniary Commitments") which is linked to payments software and which aims to improve the availability of information about assumed commitments, meeting of statutory deadlines for payment and to prevent accumulation of potential arrears.

[15] For example, in terms of comprehensiveness, indirect budget users do not provide information on their arrears.

[16] The "Rulebook" for the method and procedure for monitoring the implementation of the revised Law was published in the Official Gazette, October 23, 2015.

[17] Other supplemental steps to address these issues could include additional secondary legislation ensuring the accuracy and timeliness of reporting on outstanding commitments and arrears by users of public funds.

therefore, builds on the prior action through putting in place a central register of invoices for transactions that would allow for more efficient monitoring of commitments and arrears as recommended by the recent Functional Review of the MoF, and in line with the PFM Reform Program. The central register is intended to capture all invoices issued for commercial transactions, and, thus, ensure reliable and accurate data on incurred commitments and the level of arrears, supporting efforts to enforce the payment deadlines set out in the Law, as also supported under the Trigger.

DPL1 Prior Action #1. The Borrower, through its Ministry of Finance, adopted the framework for monitoring the implementation of the Law on Deadlines for Payments in Commercial Transactions, which has been revised to extend its coverage to include public-public transactions, including those of state-owned enterprises.

DPL2 (Indicative) Trigger #1. The Borrower, through its Ministry of Finance, (a) puts in place a central register of invoices for public-public transactions and (b) enforces payment deadlines for said transactions.

40. **Expected results:** The above actions are expected to support improved transparency and data on incurred commitments and the level of arrears. In particular, the percentage of invoice for public to public transactions recorded in the central register is expected to rise from zero at end-2015 to 100 percent at end-2018.

Public Administration (PA) Reform

41. **A key challenge facing the Serbian public sector is improving the management of public employment and the wage bill so as to support fiscal consolidation and enhance public sector performance.** The general government wage bill grew significantly in the 2000s, rising from 8 to 10.7 percent of GDP from 2001 to 2008. Measures introduced by the Government to contain the wage bill have helped to reduce it from 9.9 percent of GDP in 2014 to a projected 8.5 percent in 2016.

42. **The Government initially relied largely on across-the-board wage reductions and hiring freezes introduced in 2014 to restrain the wage bill, but this does not address more fundamental problems in human resource management**. Some sections of public employment have more employees than are required and vice-versa, undermining the efficiency of human resource management, and public sector management more generally. For example, evidence of overstaffing is found in the health, judiciary, and police and to some extent, education sectors. Because a hiring freeze is not targeted, it does not focus on these positions. A wage freeze, similarly, fails to deal with underlying problems in the structure of compensation such as complex systems of pay and grading with compensation rates above market levels in low skilled positions and below market levels for high level positions (IPSOS, 2015). As a result, equal work is not equally rewarded. Also, the complex and arbitrary nature of the compensation system undermines staff morale and renders the system vulnerable to ad hoc pressure from public sector unions.

43. **To address these problems, the government is focusing on three key activities – (a) revising the legislative and policy framework for public sector employment; (b) reforming the pay and grading system; and (c) rationalizing staffing levels in a structured manner.** These reforms are central to the PA Reform Strategy Objectives of improving organizational and functional sub-systems

of the PA and introduction of a harmonized public service system relying on merits and improved HR management.[18]

44. **In July 2015, the government adopted the Law on the Ceiling on Public Sector Employees (Prior Action #2) setting the criteria of determining the maximum number of employees from 2015 to 2018, as well as the scope and limits for reducing their number to achieve the ceiling determined by this law.**[19] To strengthen its system for controlling staffing numbers, the government has established a registry of public employees and enacted legislation to make it effective. Under the new Law, 2016 ceilings for individual institutions were set in a government decision in December 2015 implying a reduction of 14,500 permanent employees in total relative to the end-2014 baseline.[20] By end-September 2016, the net reduction was almost 22,000 relative to the end-2014 baseline (or approximately 4.4 percent), including cuts to due rationalization, retirement and other reasons. The government is focusing on rationalizing staffing levels in a structured manner. Subsequent annual decisions under the Law on the Ceiling on Public Sector Employees will set the staffing limits for future years (Trigger #2). These limits will be informed by functional reviews of staffing needs, both horizontal and for key sectors, such as health and education, which the government is undertaking supported by the World Bank. This is part of the "right-sizing and optimization" program intended to improve the organization of the public sector, the assignment of competences among tiers of government, and the organization of work processes within various institutions. Ministries are expected to simplify administrative procedures, eliminate redundant tasks, and eliminate or restructure departments with duplicate functions. Following consultations with stakeholders, a strategic staffing adjustment plan will be prepared and submitted to the cabinet. This will then be implemented, through a combination of attrition, reassignments, and dismissals. In parallel, the Government is strengthening its system of establishment control to improve payroll management.

DPL1 Prior Action #2. The Borrower: (a) adopted the Law on the Ceiling on Public Sector Employees setting the criteria of determining the maximum number of employees in the public sector, from 2015 to 2018, as well as the scope and limits for reducing their number in order to achieve the established said maximum; and (b) established, as required by said law, the first institution-level limits on the number of employees in the public sector.

DPL2 (Indicative) Trigger #2. Based on the Law on the Ceiling on Public Sector Employees, the Borrower has in 2017 set out updated institution-level limits on employees in the public sector, as determined by the Law.

45. **The government is also taking important steps to reform the pay and grading system.** The Law on the Salary System of Public Sector Employees which came into force on 9 March 2016[21] rationalizes the public pay structure helping to contain and control wage costs (Prior Action #3).[22] This involves moving down from 71 different elements of remuneration, 16 different base salaries, 900

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[18] The work on the PA Reform strategy was supported in close cooperation by the World Bank, the EU, and several bilateral donors (Germany, UK, and Switzerland).
[19] Official Gazette of the Republic of Serbia" No. 68/2015 and 81/2016-CC.
[20] The Law was enacted and published in Official Gazette, dated 4 August 2015. The decision was published in the Official Gazette dated 8 December 2015.
[21] Official Gazette of the Republic of Serbia No. 18/2016.
[22] The Law will take effect as from 1 January 2017, or 1 January 2018 for police officers and members of the Serbian Armed Forces, with secondary legislation required to set out the detailed regulations.

different job coefficients, and more than 2,200 job titles to a manageable level.[23] The Law will also regulate and streamline the public sector pay and employment legislation that currently comprises of 19 laws and a plethora of by-laws that regulate salary levels. The Government is undertaking a comprehensive job evaluation and pay grading exercise, within current fiscal constraints, with the Law setting out the principle of the grading system and the timetable for implementation of the reform. The new structure will cover all public service employees including those in education, health, social protection, culture, and sport. A Catalogue of Jobs in the Public Sector, which will be adopted according to the Law on Salary System of Public Sector Employees, will catalogue and describe all jobs in the public sector.[24] Under the proposal, all positions will be re-graded according to common criteria. Pay scales will be established for each grade, reflecting current market conditions and fiscal constraints. It is expected that a variety of pay scales and implementation strategies (for example, the extent of grandfathering) will be analyzed. Once this process is completed, new regulations governing the new pay and grading will be issued and the new pay system will be implemented. Indicative Trigger #3 supports the implementation of this process in sectors with large number of employees.

DPL1 Prior Action #3. The Borrower adopted the Law on the Salary System of Public Sector Employees to rationalize the public sector pay structure.

DPL2 (Indicative) Trigger #3. The Borrower, through its government, maps all employees within the education, health and social protection sectors to the new grades set out in the Public Sector Job Catalogue.

46. **Expected results*:*** The reforms are expected to contribute to implementation of improved control of staffing and the implementation of a new wage system in the public sector. It is expected that as of end-2018 the number of employees in the public sector, as determined by the Law on the Ceiling on Public Sector Employees, does not exceed the total of institutional-level limits set under the Law and its decisions (versus not at end-2015). In addition, the share of employees within the education, health and social protection sectors paid on the basis of their new grades set out in the Public Sector Job Catalogue is expected to increase to 60 percent by end-2018 versus a baseline of zero at end-2015.

PILLAR B: ENERGY PUBLIC ENTERPRISES

47. **Electricity and gas public enterprises are among the largest enterprises in the country and a priority for the fiscal reform agenda**. Commercialization of electricity and gas public enterprises has lagged behind despite progress in the putting in place the legislative framework for the implementation of competitive energy markets.[25] Because of their fiscal burden through government payment of debt service obligations guaranteed by the state and the fiscal risks they pose due to

[23] See World Bank. 2016. *Serbia - Program on modernization and optimization of public administration: program for results – environmental and social systems assessment*. Washington, D.C.: World Bank Group.

[24] The seven finalized sub-catalogues include 1. General government (including local self-government and provincial government), 2. Education sector, 3. Health sector, 4. Culture, 5. Sport, 6. Social Protection, and 7. Generic positions in the public sector. Before the catalogue is formally adopted by the government respective ministries should approve them. The police and defense sector will not be included in this catalogue and will prepare separate documents.

[25] The 2014 Energy Law and the adopted secondary legislation ensure a compliant legal framework for the implementation of the EU's Third Energy Package.

potential future need of government support, actions to improve the financial viability of these entities is critical to the government's fiscal consolidation efforts.

48. ***Electricity: Elektroprivreda Srbije (EPS).*** Although not requiring direct transfers from the budget, EPS relies on government support through guaranteed loans (amounting to 0.9 percent of GDP, at end 2015) to finance its investment program and more recently, operating expenditures. The financial analysis carried out by the World Bank, carried out in 2015, projected that absent measures to improve operational efficiency and financial engineering, EPS will face liquidity issues by 2017. Key challenges include: (a) below-cost tariffs for regulated consumers; (b) lack of payment discipline particularly from public sector entities (collection rate of about 50 percent in 2014); (c) inadequate governance, which translated, among others, in overemployment; and (d) obsolete infrastructure and relatively low operational performance.

49. **Over the past two years, the Government has taken bold steps to put the electricity sector on a financially sustainable footing.** Corporate restructuring and financial consolidation plans (FCPs) for EPS were adopted in November 2014[26] and June 2015,[27] respectively. The former plan led to streamlined organizational structure and management.[28] The FCP (2015–2019) includes time-bound measures aimed at transforming the company into a commercially and financially viable utility. Specific actions target: (a) increased revenues through the establishment of a tariff adjustment path aiming to reach market parity levels by 2019; (b) decreased operational expenditures, including time-bound targets for labor rightsizing, improved collections, and reduced distribution losses; and (c) changes in legal status from a Public Enterprise into a Joint Stock Company so as to improve corporate governance.

50. **The DPL series will support measures deemed critical to the achievement of targets set out in the EP FCP.** Specifically, measures on tariff adjustment and related protection of vulnerable households, and labor rightsizing. EBRD is supporting complementary policy actions set out in the FCP under its restructuring loan.

Electricity Tariff Adjustments

51. **This DPL supports the implementation of the second electricity tariff adjustment set out in the FCP, as a critical measure to improve the financial viability of EPS.** The first guaranteed supply electricity tariff increase in the adjustment path was a 4.5 percent rise which took place in August 2015 which, together with the creation of a 7.5 percent excise tax, results in a 12 percent rise in household prices. This DPL supports the second tariff adjustment in 2016 of 3.8 percent (Prior Action #4). The Indicative Trigger #4 for the second DPL supports a further increase in 2017, informed by additional analysis based on the progress in the implementation of other measures in the FCP as well as in view of regional electricity prices. While relatively modest, such increases would also allow EPS to cover about 95 percent of its operational costs by mid-2018. These adjustments would allow

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[26] Program for Reorganization of EPS. Government Conclusion 05 No. 023-15149/2014.

[27] Plan for Financial Consolidation of Public Enterprise EPS. Strictly Confidential Government Conclusion 05 No. 00-169/2015.

[28] The new structure became effective on July 1, 2015 and all 7 subsidiaries for electricity generation were merged into EPS and 4 subsidiaries operating the distribution network were merged into one company: EPS Distribution. In 2016, EPS supply was merged with EPS. As a result, there are now only two companies: EPS covering the activities of mining and power generation, supply, and retail activities and EPS Distribution for the operation of the distribution system.

convergence from 64 percent of regional wholesale parity levels in mid-2015 to approximately 80 percent by mid-2018.[29] Regional wholesale prices are a relevant benchmark in the case of Serbia because: (a) prices for consumers in the free market (mostly industry) are aligned with regional wholesale market prices (adjusted for import costs) and (b) convergence to regional market prices will support the phasing out of price regulation four households, in line with country's commitments toward the EU. Transmission and distribution fees are determined by the regulator according to a cost-based methodology.

52. **To accompany tariff adjustments, the government put in place a targeted assistance program to protect vulnerable households**. Electricity accounts for the largest share (72 percent) of household's energy expenditures, especially for the poorest. It is estimated that 36 percent of households in the lowest quintile spend more than 10 percent of their budget on electricity. To address affordability concerns, the government put in place an 'Energy Vulnerable Customer Program' which provides a partial discount of electricity and gas bills depending on the number of household members. While designed with relatively good targeting, the current Energy Subsidy Program for energy vulnerable households is fairly limited in terms of its coverage and has low take up (see Annex 5).

Table 4. Expected Impact of the Amendments of the Energy Vulnerable Customer Program

Description/Year	2015	2016 simulations*
Total budget allocated (million RSD)	900	1,785
Number of households covered	60,500	80,600
Coverage of electricity vulnerable and poor (% of households)**	5	9

Note: *Simulations based on the 2015 Households Survey and provisions of the new Decree for the Energy Vulnerable Customer Program and program allocation in the 2016 Budget.
** Electricity vulnerable are defined as those households spending more than 10 percent of their budget on electricity and poor are defined as households in the bottom quintile (B20) of the income distribution.

53. **The proposed DPL also supports the strengthening of the Energy Vulnerable Customer Program and an increase in its budget allocation for 2016 (Prior Action #4).** The new Decree on Energy Vulnerable Customers was approved in December 2015, entering into force in January 2016. The decree aimed to increase program coverage and strengthen protection of vulnerable populations in the face of rising electricity tariffs. It significantly increased the electricity consumption thresholds, allowing energy vulnerable households who have higher consumption (for example, due to electric heating) to still qualify for the protection scheme. In addition, under the 2016 Budget Law, the budget allocation was increased from RSD 900 million in 2015 to RSD 1,650 million in 2016. Table 4 presents the expected increase in coverage of the program in 2016 resulting from the budget increase and amendments to the program. There have been some concerns of low take-up, possibly due to the changes in the program's implementation mechanisms, although it has improved recently. The government is monitoring program implementation to make necessary changes which would be supported under Trigger #4.

Prior Action #4. The Borrower: (a) through its Council of the Energy Agency, approved a 3.8 percent increase of the electricity tariff for guaranteed supply; (b) amended the Energy Vulnerable Customers

[29] In line with the tariff methodology for the public supplier, the convergence will be measured by the difference between the wholesale price charged by EPS and the prevailing regional wholesale price set on the basis of neighboring power exchanges (Hungarian exchange HUPX).

Program to increase coverage of targeted beneficiaries; and, (c) increased the budget for said program.

DPL2 (Indicative) Trigger #4. The Borrower: (a) through the Council of the Energy Agency, approves an additional increase of the electricity tariff for guaranteed supply in 2017; and (b) takes measures, if necessary, to protect vulnerable households.

EPS Rightsizing

54. **Rightsizing of EPS's labor force is an important measure to reduce costs, thereby improving the financial position and efficiency of EPS**. The total headcount of full-time employees was 32,140 by end-2014 and salary costs have been increasing.[30] Based on a benchmarking analysis with companies operating in Western and South-eastern Europe, as well as with internal best performing units in EPS, the potential for wage bill reduction was estimated to be about 15 percent. This cost reduction target translates in the FCP into a net reduction of employees of 5,000 between 2016 and 2019. The rightsizing not only focuses on costs but also on improving the adequacy of the workforce (for example, age and level of education) and operational efficiency. Also, rightsizing is meant to be implemented in parallel with technological improvements in EPS's operations to bring them closer in line with commercial practices.

55. **The proposed DPL supports the implementation of the 2016–2019 EPS labor optimization plan.** The plan was drafted in line with international good practice and national legislation and regulations. It sets out the overall rightsizing targets for the medium term, processes, and timeline for their implementation. Labor reduction will be achieved through a combination of natural attrition, voluntary separation, and involuntary separation. The implementation focus of the plan is on the first year, during which a labor reduction of between 1,500 to 2,000 employees through attrition and voluntary separation is foreseen. For workers opting for voluntary separation, financial incentives, well above those specified in the legislation for State Owned Enterprises, will be provided according to eligibility criteria based on the worker's age and years of service. The plan was adopted by the EPS Supervisory Board on August, 5, 2016 (Prior Action #6). Implementation is ongoing, with the first call for workers interested in voluntary separation launched on September 1, 2016 (with the deadline extended to October 15, 2016, to enable more interested employees to apply). As of October 15, 2016 about 1,800 EPS employees had voluntarily applied to leave the company.

DPL1 Prior Action #5. The Borrower, through the Supervisory Board of Elektroprivreda Srbije (EPS): (a) adopted a labor optimization plan for 2016-2019 setting out the medium-term targets, process, compensation packages, selection criteria, grievance mechanisms and timeline for reductions in staffing; and (b) issued the first call for voluntary separations to implement the 2016 target for net staff reduction.

DPL2 (Indicative) Trigger #5. The Borrower, through the Supervisory Board of EPS, implements the labor rightsizing in 2016 and 2017 in accordance with the EPS Labor Optimization Plan.

56. ***Natural Gas: Srbijagas.*** JP Srbijagas generates significant losses each year which reached €392 million (1.2 percent of GDP) in 2014. Past losses have accumulated to such an extent that by end-2015

[30] EPS has in recent years added 4,400 more employees through mergers of subsidiary to parent company MB Kolubara and overtaking of employees from unprofitable and previously spun-off companies. These mergers increased staff costs from RSD 53.8 billion in 2013 to RSD 56.7 billion in 2014.

negative equity (net asset value) of €563 million was recorded in JP Srbijagas stand-alone financial statements. Given negative operating results, the company has covered expenses, including its substantial investment program, by assuming new government-guaranteed debt. Outstanding long-term loans to commercial banks amounted to €657 million in December 2015. To honor debt service obligations, the government has been making transfers to the company for it to be able to settle interest payments and due debt installments. This has in parallel led to an accumulation of short-term liabilities toward the government amounting to €476 million (RSD 57.9 billion) at year-end 2015. Total liabilities of Srbijagas amounted to €1.62 billion (RSD 197 billion) in December 2015, close to 5 percent of GDP.

57. **Key challenges in the gas sector include** (a) lack of payment discipline and low collection of due receivables; (b) high levels of debt as described above; (c) unsustainable investment program with most CAPEX targeted at distribution expansion which failed to generate positive incremental revenues; (d) acquisition on non-core business assets through debt to equity swaps with insolvent gas consumers (mostly state-owned); and (e) inadequate internal controls. In relation to the first challenge, tolerance of non-payment has been used as a means to support the operation of commercial SOEs and district heating companies. As of December 2015, more than 68 percent (€ 486 million) of gross and 74 percent (€127 million) of net trade receivables related to state-controlled entities. Recent evidence of further sizeable arrears due to Srbijagas from Azotara and MSK (€80 million in total as of October 2016) highlight the need to address both the stock of arrears and prevent their future accumulation.

58. **The government approved a corporate restructuring plan for JP Srbijagas in December 2014.** This is to transpose unbundling provisions in line with the requirements of the Second EU Energy Package. Two subsidiaries for transmission and distribution were registered in August 2015. While this is a positive step, substantial efforts are still needed to implement the unbundling as noted by the Energy Community.[31] In an effort to refocus Srbijagas' business, the government has initiated the divestment of part of Srbijagas non-core assets in 2015, including Agroziv (a poultry farm). To improve liquidity, in February 2015, an extraordinary transport fee was introduced to allow Srbijagas cover part of its debt repayment obligations; providing an estimated €15-17 million in additional revenues per year. Together with an improvement in collection of past receivables between 2014 and 2015, Srbijagas' financial statement improved in 2015. But even so, the company was unable to report positive cash flow in 2015, and a medium term FCP is necessary.

59. **To sustain improvements in the financial position of Srbijagas, the DPL series supports the implementation of reforms laid out in the company's FCP**. Based on the findings of substantial analytical work carried out with the World Bank, the government prepared and adopted a FCP for Srbijagas in March 2016 (Prior Action #6). Measures outlined in the plan target market and development strategy for the sector, increased revenues by improving the bill collection rate and reduced costs, such as addressing the unsustainable debt burden, unprofitable investment plan and imperfect corporate governance framework of the company. The government is moving forward in the implementation of the plan, specifically by reducing the large outstanding stock of debt through early repayment and renegotiations of high-cost debt.

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[31] On October 12, 2016, the Government of Serbia in consultation with the Energy Community, adopted a conclusion setting out a time bound action plan for the effective implementation of the Srbijagas unbundling. Unbundling of the company is also one of the benchmarks for the opening of Chapter 15 – Energy in the context of Serbia's EU accession process.

60. **The proposed triggers in the second DPL would support implementation of key measures laid out in the FCP.** These include enforcing payment discipline by setting out mechanisms for discontinuing gas supplies in case of non-payment, improved economic and financial assessment[32] of the company's investment program so as to reduce potential inefficient spending (and build-up of related debt as mentioned above). In addition, the program would support the appointment of an audit committee to increase the quality of internal controls, internal and external audits, and the issuance of a report of the said committee on its activities (Trigger #6).

DPL1 Prior Action #6. The Borrower adopted a financial consolidation plan for Srbijagas that defines measures to increase revenues and reduce costs.

DPL2 (Indicative) Trigger #6. The Borrower improves Srbijagas financial management through: (a) implementation of the policy for gas supply interruption based on the government adoption of a conclusion defining the mechanisms to discontinue gas supplies to commercial consumers in arrears; (b) the Ministry of Mining and Energy issues an opinion on an investment appraisal methodology as adopted by the management of Srbijagas; and, (c) the Srbijagas audit committee documents its activities as the body in charge of the oversight of the system of internal controls, internal audit, and external audit.

61. **Expected results.** The expected results of EPS-related policy actions under the DPL series include: (a) increased convergence of the guaranteed supply electricity tariff to reach market parity levels, if this tariff remains in effect until 2017:[33] Baseline (end-2014): 64 percent; Target (end-2018): 80 percent; (b) Increased number of annual beneficiaries of the Energy Benefit Program from 60,600 households in 2014, of which 27 percent are female-headed households,[34] in 2014, to 100,000 households in 2018, of which 30 percent female headed; (c) A reduction in EPS's annual wage bill by 10 percent or more in 2018 relative to 2015, resulting from the implementation of the labor optimization plan. For Srbijagas, expected results include an increase in the company's collection rate of current receivables due to 87 percent (averaged over 2016-2018) from the baseline of 80 percent in 2015 and having in 2018 approved a 10-year development plan for the gas Transport System Operator and 5-year development plan for the Distribution System Operator in accordance with the economic and financial appraisal methodology adopted under Trigger #6.

PILLAR C: TRANSPORT PUBLIC ENTERPRISES AND STATE-OWNED COMPANIES

62. **Serbia's transport sector public enterprises and state-owned companies have in recent years received significant direct budget support, and the fiscal cost of payments for activated government guarantees has been sizeable.** Furthermore, improving the quality of infrastructure and service delivery in a fiscally conscious way is critical for fiscal consolidation as well as for facilitating economic growth and regional integration. According to the 2015–2016 Global Competitiveness Report, Serbia ranked 114th out of 144 countries on the quality of roads and 90th out of 104 countries on the quality of its rail infrastructure, a decline from its 83rd position in the previous year. Limitations in financial resources alone cannot account for the inadequate performance and unsatisfactory outcomes in the

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[32] Such an economic and financial assessment refers to the definition of a systematic process for examining alternative uses of resources, focusing on assessment of needs, objectives, options, costs, benefits, risks, funding, affordability and other factors relevant to Srbijagas' investments decisions.

[33] In accordance with the 2014 Energy Law, the Energy Agency will publish by May 2017 a report on the need to continue the regulation of the guaranteed supply tariffs.

[34] The share of female shared households is not currently monitored. Estimates are the World Bank's based on the 2013 Households Budget Survey data.

sector. Railways of Serbia has been characterized by low labor productivity,[35] overstaffing, low railway traffic intensity and a lack of investment in priority network upgrading based on economic efficiency criteria. Absent reform, railway operations, with the current size of the network, labor force and assets could not be sustained without significantly more government financial support. In the road sector, inefficient asset management practices, where maintenance contracts are not procured on a competitive basis, the lack of clarity on year to year budgetary allocations for the national road network and a large backlog in rehabilitation needs estimated at about US$1 billion are the main reasons for the unsatisfactory condition of the road network. Across both sectors enhanced efficiency and quality of service delivery require improvements in sector-level policy and governance, as well as in the corporate governance and operational management of the public transport companies.[36]

63. **The government started the reform process in the railway sector several years ago in large part to control the large subsidies in the sector.** Before its reorganization into 4 companies, *Zeleznice Srbije* (Serbian Railways) had been the largest recipient of direct budget subsidies (0.3 percent of GDP in 2015) and debt service for activated guarantees (0.13 percent of GDP in 2014) are were among the largest to SOEs. These direct budget subsidies do not take into account subsidies/non-payments for electricity purchases or operating losses. When included, budget support averaged 0.9 percent of GDP over 2008 to 2013. Railway reforms started with the adoption of modern legislation and the establishment of the railway regulatory body in line with the EU acquis.

64. **As a first step, in early 2015, the Railway Reform Steering Committee was established, and the company was unbundled into three operating companies (passenger, freight, and infrastructure) and a transitional company**. The unbundling became effective August 10, 2015. The primary role of the transitional (fourth) company is to address the resolution of surplus property that is not state property, and to wind itself down, with a life determined by the time for this process. The Steering Committee adopted a Railway Reform Plan (2016-2020) in October 2015, informed by a 2014 World Bank Railway Policy Note and an EU-funded consultancy report. This plan covers the financial and corporate reform of railway companies and centers on asset disposal, network optimization, and staff rationalization. Underlying the reform plan's actions is the need to change the business culture in the sector to enable and empower the new railway companies, once established, to operate commercially.

65. **The proposed actions supported under the DPL are key to implementation of the railways sectoral reform agenda.** Positive progress has been made flowing from the adoption of the reform plans for the railway companies. This includes putting in place and operating under the new contractual framework for the sector and for the newly created railway operating companies, for example, through track access charges and public service obligation (PSO) for the infrastructure and passenger railway companies respectively (Prior Action #8). The PSO enables the government to define the extent and type of passenger railway services which the public sector supports, better targeting direct budget support. Clear performance criteria can help improve service delivery,

[35] Labor productivity was estimated at about 30 percent of the EU-27 average (comparison is with EU-27 instead of EU- 28 because the data is from 2012 before Croatia became the 28th member of the EU). The sum of passenger-km and ton-km divided by total route km was about 30 percent of the EU-27 average – 11 percent for passenger and 54 percent for freight traffic. These figures are not expected to be have changed much since the analysis of the 2012/2013 figures.
[36] See, for example, the 2011 Reform Action Plan for Roads of Serbia prepared under the World Bank supported Corridor X Highway Project and World Bank (2014), Republic of Serbia: Accelerating Railway Reforms in Serbia: A Roadmap.

management accountability for performance, and inform decisions on future network configuration and services. The October 2015 rail reform plan included Key Performance Indicators for the period 2015–2020 for each of the operating and infrastructure companies, with performance criteria included in the respective 2016 business plans of the new railways companies (Prior Action #7).

66. **The indicative trigger in the second operation focuses on implementation of additional measures to put the new rail companies on a sound financial footing and improve their efficiency**. Debt was allocated to the three new operating companies at their unbundling. Any government guarantees of debt continue to hold and are expected to be assumed by the government. While this is expected to help improve the financial standing of the new operating companies, there is a need to initiate the implementation of a plan to address their historic commercial debt so as to ensure that they are not burdened with previous debt which they cannot pay and which would otherwise impede their financial viability. Improving financial transparency standards will also be important for obtaining clear information on the performance of the new companies, to guide decisions by management and to guide the allocation of public sector support. A first step, as required by legislation, is preparing annual financial statements for the new rail companies under International Financial Reporting Standards (IFRS), as required for all Serbian companies under the Law on Accounting, and making them public on the internet, per the Public Enterprise Law. Modernization of financial and accounting systems of the railway companies will also be needed to allow effective implementation of IFRS.

DPL1 Prior Action #7. The Borrower: (a) implemented a new framework for railways financing through conclusion of the track access contracts between the state-owned infrastructure rail company and the state-owned freight and passenger rail companies and approving a public service obligation agreement; and (b) adopted new performance criteria for the state-owned infrastructure, freight and passenger rail companies.

DPL2 (Indicative) Trigger #7. The Borrower: (a) through the respective railways operating companies, approves and initiates the implementation of a plan to restructure their commercial debt in a manner that places the companies in a position to be financially viable; and (b) through the management of the respective railway companies, makes publicly available the annual financial statements of the new railways companies prepared under International Financial Reporting Standards, as required under the Law on Accounting, and modernizes their financial and accounting systems to allow effective implementation of IFRS.

67. **Labor rightsizing is an important factor in delivering improved efficiency for the railways companies.** For the restructuring process to deliver its objectives of improving the efficiency of the sector, it will be important to move forward in a fair and consistent way, with firm targets for labor rightsizing and adequate plans for the process and support to affected workers. In an important step forward in this process the four railway companies adopted "Labor Optimization" Plans in early September 2016 and October 2016, which were amended slightly in November 2016 to reflect updated agreements with the trade unions on the level of severance payments and modifications to the selection criteria (Prior Action #8) setting out the medium-term targets, process, compensation packages, selection criteria, grievance mechanisms and timeline for reductions in staffing. Unions were consulted on the packages. With funding for the severance packages also in place the process can now move forward, targeting a reduction of at least 2,700 in 2016 and a total reduction of at least

5,500 employees through 2020 or 30 percent of the end-2014 workforce.[37] Subsequent to the adoption of these plans the railways companies have moved forward with implementation, for example, presenting for approval to the National Employment Service (NES) retrenchment programs in line with legal requirements and taking steps to identify employees for the implementation of the 2016 targets through issuance of a query to employees. As of October 24, 2016, employees expressing interest in taking a severance package had reached around 65 percent of the 2016 targeted numbers for staff reduction. Implementation of rightsizing in subsequent years is an indicative trigger for DPL2.

DPL1 Prior Action #8. The Borrower: (a) through the Decisions of the General Assemblies of the respective railway companies, adopted labor optimization plans for 2016-2020 setting out the medium-term targets, process, compensation packages, selection criteria, grievance mechanisms and timeline for reductions in staffing; and (b) through the management of the respective railways companies, initiated the 2016 target for staff reduction by communicating to the companies' respective employees the option for their participation.

DPL2 (Indicative) Trigger #8. The Borrower, through the General Assemblies of the respective railways companies, implements labor rightsizing in 2016 and in 2017 in accordance with their respective Labor Optimization Plans.

68. **On roads, the focus is on improving the sector's efficiency through an improved policy framework.** Public enterprise Roads of Serbia (*Putevi Srbije*, PERS) maintains and rehabilitates the National Road network (about 17,000 km) and Motorways (600 km). Because only the motorways are tolled, Roads of Serbia received substantial direct budget support, for the remaining maintenance work, equal to, 0.2 percent of GDP in 2015.[38] Reforms needed to improve sector efficiency include the introduction of monitorable service-level agreements between the transport line ministry and Roads of Serbia and introduction of competitive tendering for road maintenance works. The adoption of a medium-term service-level agreement with clear goals and performance targets linked to secure financing is proposed as a trigger and would support improved long-term planning, and lead to a better quality of investment and asset preservation, and improved accountability by Roads of Serbia. The ongoing World Bank-supported Road Rehabilitation and Safety Project is providing support to introduce efficiency in the tendering of maintenance contracts.

DPL2 (Indicative) Trigger #9. The Borrower, through its government, prepares a framework service-level agreement with PERS defining standards for different road classes, committing to provide the agreed financing for roads and holding PERS accountable for service delivery.

69. **Expected results:** Prior Action #7 on railways financing policy and business performance criteria, along with the trigger on commercial debt restructuring and the establishment of financial transparency standards and modernized financial accounting systems are expected to contribute to improved efficiency and financial performance resulting in a reduced level of annual direct budget operational support to the railways companies (down from RSD 13.5 billion in 2015 to RSD 11 billion

[37] The railways companies are in the process of carrying out a survey of potentially interested employees in voluntary separation and have prepared the draft retrenchment programs required by the Labor Law in cases of "technological surplus" labor with a view to adopting them and starting implementation of such separation in late October 2016.

[38] Starting from 2012, the financing model for the roads changed with some revenues from tolls and excises redirected from the company to that of the government budget. The budgetary transfers have been lower than what Roads of Serbia used to receive through the excise tax on fuel.

or below in 2018, which would be just for infrastructure and passenger companies) and improved labor productivity and asset utilization, up by 15 percent in 2018 relative to 2015 for both indicators.[39] Prior Action #8 and Trigger #8 on labor rightsizing in the railways companies targets a reduction in their combined wage bill of 25 percent by 2018 relative to the 2015 baseline. The qualitative result indicator associated with Trigger #9 is that by the 2019 budget maintenance levels for the different road classes are agreed between the government and Roads of Serbia and associated funding levels committed.

ANALYTICAL UNDERPINNINGS

70. **The design of the proposed DPL series and the proposed prior actions are informed by substantial recent and ongoing TA and analytical work, undertake with strong collaboration with other development partners**. Table 5 indicates specific sectoral work which complements the overarching analysis in the recent Serbia Public Finance Review and SCD reports.

Table 5. DPL Prior Actions and Analytical Underpinnings

Prior actions	Analytical Underpinnings
PA#1 on monitoring framework for implementation of revised Law on Deadlines for Payments in Commercial Transactions	2015 PEFA report and World Bank Input to the Government's PFM Reform Program highlighted need to improve arrears monitoring, payment discipline and ex ante commitment controls.
PA#2 on the Law on Ceiling on Public Sector Employees and institution-level limits on employees	World Bank wage system TA and TA for preparation of the Modernization and Optimization of Public Administration PforR highlighted fragmentation of wage system and need for staffing limits and controls. Serbia Rightsizing and Restructuring Project, funded by the EU Commission, supports preparation of series of functional reviews aimed to identify options for optimization and rightsizing in the public sector.
PA#3 on the Law on the Salary System of Public Sector Employees	
PA#4 on guaranteed supply tariff increase and increased funding to program to protect vulnerable consumers	World Bank TA to EPS to support the preparation of the FCP (finalized) and updated in 2016 outlined measures to support financial sustainability of company, including tariff rises and reductions in labor costs through rightsizing process. TA: Energy Affordability, Tariff Increase, and Protection of Vulnerable Populations in Serbia carried out quantitative analysis to assess the implementation of the ongoing Energy Vulnerable Customer program and highlighted the need for additional funding, implementation challenges and provided policy recommendations to address these.
PA#5 on EPS labor optimization plan	
PA#6 on financial consolidation plan (FCP) for Srbijagas	Extensive TA to Srbijagas provided analysis to inform measures set out in the FCP. Specific issues analyzed included: (a) financial due diligence, (b) corporate governance, (c) market analysis, (d) options for debt restructuring, and (e) analysis of the distribution sector.
PA#7 on railway companies financing policy and business performance criteria	World Bank Accelerating Railway Reform in Serbia 2014 set out an action plan for sector and corporate governance reforms to improve sector efficiency; EU-funded consultancy in 2015 developed detailed recommendations for improvements in institutional and corporate performance of the rail sector. These were preceded by several TAs financed by the EU and the EBRD that provided a sound analytical framework to guide preparation of Public Service Obligation contracts for passenger transport, Multi-Annual Infrastructure Contracts, Track Access Charge regime and asset management plans.
PA#8 on railway companies labor optimization plans	

[39] Labor productivity as measured by train kilometers per employee and asset utilization as measured by passengers per kilometer of track and ton per kilometer of track.

4.3 LINK TO CPF, OTHER BANK OPERATIONS, AND THE WORLD BANK GROUP STRATEGY

71. **The proposed DPL series will contribute 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 will contribute 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.

72. **The design of the DPL builds on, and is coordinated with, several other World Bank ongoing or activities under preparation.** The DPL series is firmly anchored in recent World Bank analytical work and TA, including those listed above and the recently completed Systemic Country Diagnostic and Public Finance Review. In addition, it builds on knowledge and expertise from recent projects, including the Floods Emergency Recovery Loan, and is closely coordinated with, and complements, other operations including the Corridor X Highway Project and the Road Rehabilitation and Safety Project which are supporting road sector reforms.

73. **Three operations in particularly are closely linked to the DPL series.** The first is the SOE Reform DPL series (first operation approved by the Board in March 2015, the second in October 2016) which supported reforms: to accelerate the restructuring and divestiture program for the PA portfolio and selected SOEs operating in the commercial sector; to strengthen the governance, regulatory and institutional framework, and monitoring and transparency arrangements for SOEs; and to mitigate the social and labor market impact of the SOE reform program. The latter two pillars link closely to the reforms in the energy and transport pillars under this DPL series. The second related operation is the PforR on Modernization and Optimization of Public Administration. This aims to support implementation of the Government's Action Plan for Implementation of Public Administration Strategy with results areas aiming to improve human resources management, financial management and procurement management. The PEPU DPL is coordinated with the PforR, supporting key legislative and policy reforms related to PforR results areas. The third related operation is the Competitiveness and Jobs project (Board approval in September 2015) which aims to facilitate job creation and to strengthen the capacity of the NES; to improve the effectiveness of active labor market programs; and facilitate the transition of social assistance beneficiaries into formal jobs.

4.4 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

74. **The government has designed their reform agenda through a consultative process.** Most of the reforms supported by this operation have been developed including consultations organized by the government, for example on the broad ERP and the PFM Reform Program. For the public administration rightsizing, steps are being taken to improve the consultation process, which is part of the Action Plan in the World Bank-supported PforR program. Electricity price increases followed consultation and public awareness process established by the regulator.

75. **On the labor rightsizing measures, the government has made efforts to involve respective unions in the reform process.** The public sector rightsizing covers a broad range of sectors and type of

workers (for example, workers with the status of civil servants in the ministries, and workers to which labor law and various collective agreements apply in health, education, public services). Unions were involved in consultation around the adoption of the Law on the Ceiling on Public Sector Employees in 2015. In the case of rightsizing at EPS, unions participated in various stages of the process including negotiating voluntary compensation packages, involvement in the Call for voluntary applications and as members of the Employees support teams. The entire rightsizing process in EPS in 2016 is based on the voluntary separation of workers, who will retire upon termination of employment with EPS. In the case of the railways companies, unions participated in the negotiations around severance packages and the selection criteria for the retrenchment. The Labor Optimization plan contains a stipulation that the application of involuntary separations will be carried out in collaboration with the unions.

76. **This operation is prepared in close coordination and cooperation with relevant stakeholders, including development partners**. The World Bank team has collaborated and consulted closely with other development partners, including the EU, EBRD, and IMF, with regular exchange of information and participation in joint meetings with technical counterparts, contributing to the design of the program. World Bank support to PFM and public administration reforms is closely coordinated with the IMF and the EU.[40] Electricity sector reforms in particular are coordinated with the IMF and with EBRD. Specifically, EBRD has recently extended a €200 million restructuring line to help EPS to restructure its balance sheet and support the implementation of policy actions, complementary to those supported under the DPL, aimed at improving the commercialization of the company, raising standards of corporate governance and improving energy efficiency. Policy actions and World Bank analysis in the energy and transport sectors have also helped inform the dialogue under the IMF program on issues such as company rightsizing, financing policy, debt restructuring, and electricity price increases, among others. In railways, in addition to the World Bank, a number of IFIs, including the IMF, are supporting the sector's reform and restructuring, with the EU financing supporting TA. IFIs, including also EIB and EBRD, are invited to meetings of the High Level railway reform steering committee.

V. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

77. **Some of the DPL prior actions will 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.** Reforms supported by the DPL which will have negative distributional and social impacts are: (a) workforce rightsizing in the public administration, EPS, public railways companies and the public administration (Prior Actions #2, 5, 8), and (b) higher electricity costs (Prior Action #4), including for poor and vulnerable consumers. The overall poverty impact is expected to be limited given that (a) mitigating measures are in place, including compensation packages for laid off workers, existing programs of employment support and labor regulations, (b) the affected workers tend to be in the middle and upper quintiles of the income distribution, and (c) the government increased the 2016 budget to expand the targeted Energy Vulnerable Customers Program and the 2016 electricity price increase is relatively low. The new Law on the Public Sector Wage System (Prior Action #3) is not expected to have significant adverse distributional impacts to the extent that the implementation of

[40] For example, the PfoR program supports the same government program (though different aspects of it) as the EU's Sector Budget Support instrument and the EU Commission also provides funding for the functional reviews to identify options for optimization and rightsizing in the public sector.

the Law includes only the re-categorization of public workers into harmonized categories, but no adverse salary adjustments.

Poverty and Social Impacts of Prior Actions Relating to Labor Rightsizing

78. **The labor rightsizing in the public administration, EPS and Railways Companies can adversely impact affected workers.** As mentioned above, Prior Action #2 entailed the reduction in public administration workers by 14,500, mainly in the Health, Education and Interior sectors and local public enterprises. Prior Actions #5 and #8 target staff reductions in EPS (5,000 workers over 2015 to 2019) and Railways Companies (5,500 over 2016 to 2020). The rightsizing in these three sectors (public administration, railways and EPS) will be carried out as three distinct processes with separate consultations with unions (discussed above in section 4.4). Quantitative analysis to inform the PSIA based on company records and household surveys, shows that potentially affected workers tend to be located in the middle and top quantiles of the income distribution and that they are not amongst the most vulnerable[41] (See Annex 5 for more details). However, workers and their families will be affected. While educated, workers in rail and EPS tend to be older and in the same position for a long time. They may not have the right skills set to be competitive in today's labor market, which is already stagnant with high unemployment. Some workers, particularly from railways companies, are located in small towns or in regions (for example, in Southern and Eastern Serbia) where the prospects of finding new employment can be weak. Previous qualitative research of workers retrenched from PA companies suggests that their best chances of reemployment would be in informal casual jobs.[42]

79. **Serbia has in place a relatively well developed policy and legal framework on labor relations and retrenchment along with an institutional system which is generally adequate, although some gaps exist**. Serbia's legal framework is generally in line with international standards. Existing labor legislation provides adequate protection of workers in instances when due to technological, economic or organizational changes a particular job becomes redundant or volume of work would be reduced. In such cases the Labor Law requires that the employer prepare a retrenchment plan, which must be consulted upon with Unions, with Laws and collective agreements provide provisions for redundancy (severance) payments and formulas for its calculation. However, recent environmental and social systems assessments carried out for the purpose of the World Bank supported Modernization and Optimization of PforR, indicate that there is a reason for caution. The assessment identified gaps related to the consistent implementation of consultation with workers in the context of the public administration entities, and to monitoring and evaluation of the retrenchment process, more specifically the status of the affected employees after they receive severance payments.

80. **To address the above gaps in the public sector rightsizing program, a series of measures will be implemented in the context of the above mentioned PforR.** The Program includes an action plan with specific measures to address the identified shortcomings, such as improve consultation with worker and unions, identification of staff at the Ministry of Public Administration and Local Self Government to coordinate, monitor and report on the rightsizing process and its effects, prepare selection criteria for selection of employees who will be made redundant, and establishment of

[41] Cancho, Cesar and Trang Van Nguyen (2016) Poverty and Social Impact Analysis of Workforce Rightsizing in the Public Sector in Serbia: Discussion Draft. Unpublished mimeo.

[42] Ruggeri, Caterina (2014) Addressing the Poverty, Gender and Social Impacts of Privatizations in Serbia: Discussion Draft. Unpublished mimeo.

monitoring of severance payment disbursement and status of retrenched workers. The implementation of the action plan will be monitored during the implementation of the PforR.

81. **To minimize adverse effects on affected workforce, the design of the Labor Optimization plans for EPS and the railway companies in Prior Actions #5 and #9 was informed by the domestic policy and legal framework and international good practice**. The EPS and railways' labor optimization plans rely as much as possible on natural attrition and voluntary applications for separation. Workers who opt for early retirement will also receive stimulative packages. In the case of involuntary separation, or workers who are declared redundant due to business reasons, workers will receive compensation packages above the minimum required by the Labor Law and will have the right to receive unemployment benefits from the NES, health insurance and pension benefits for the period while they are registered with NES. Also, the retrenchment plans set out grievance mechanisms and clarify timelines and responsibilities for the processes (with EPS having established a separate grievance unit within the legal department, for example).

82. **The NES has already in place specific measures to support retrenched workers and its capacity and effectiveness is being strengthened**. This category of unemployed persons is considered one of the priority groups for the NES. Measures of support include job search counseling; trainings for prequalification, psychosocial support and opportunities to participate in public works. The SOE Reform DPL series and the World Bank's Competitiveness and Jobs project, as well as other partners, also support NES. For example, the third pillar in the SOE Reform DPL series supports the government's adjustments in the design of its public works program so that it can better serve as an additional safety net for vulnerable groups, including redundant workers, and an assessment of how low-paying work can become more viable in the formal sector in Serbia, addressing an important barrier for re-employment of redundant workers. The Competitiveness and Jobs project aims to facilitate job creation and to strengthen the capacity of the NES by enhancing the effectiveness of the NES labor intermediation services for employers and the unemployed; improving the effectiveness of active labor market programs; and facilitating the transition of social assistance beneficiaries into formal jobs.[43]

Poverty and Social Impacts of Higher Electricity Costs

83. **The 2016 increase in household (guaranteed supply) electricity tariffs by 3.8 percent is expected to have a limited adverse impact on poverty and energy affordability in the short run**. In 2013, more than 3 in 5 households in the bottom income quintile in Serbia already report that they cannot keep their home adequately warm.[44] The poorest quintile and single elderly households, spent more of total expenditures on electricity than the average, 8.9 and 14.9 percent respectively. The effect of the electricity tariff increase of 3.8 percent in 2016 is simulated to have marginally increased the burden of electricity spending in total household budget: by 0.17 percentage points for the bottom quintile and by 0.13 percentage points for the average. The higher tariff is also estimated to have a limited impact on the overall poverty rate (0.2 percentage points) when measuring poverty using an anchored relative poverty line (60 percent of the median household consumption).[45] The

[43] World Bank. 2015. *Serbia - Competitiveness and Jobs Project*. Washington, D.C.: World Bank Group.
[44] World Bank (2016) How Vulnerable are Serbian Households to High Energy Expenditures? Energy Affordability, Tariff Increase, and Protection of Vulnerable Populations in Serbia. Unpublished mimeo.
[45] Relative poverty rate is estimated at 15 percent, using the 2013 Household Budget Survey. For more details on the simulation see Nguyen, Trang Van and Monica Robayo-Abril (2016) Energy Affordability and Impacts of Tariff Reform on Household Welfare in Serbia. Unpublished mimeo.

share of electricity poor households, that is, those with electricity accounting for more than 10 percent of spending, is expected to increase the most for the poorest quintile and elderly living alone (both by 1.5 percentage point). Although the 2016 tariff rise impacts are limited, the poor and vulnerable may still find it difficult to cope after already facing a 12 percent price rise in 2015. Using the cumulative electricity price increase of 16 percent (initial 12 percent in August 2015 plus the prior action 3.8 percent increase in 2016) poverty (using an anchored relative poverty line of 60 percent of median household income) is projected to increase from 15.0 percent to 16.0 percent.[46]

84. **Recognizing the need to protect vulnerable households against high energy expenditures, the government has increased the budget allocation for the existing energy bill discount program (supported under the DPL as part of Prior Action 4).** Following an initial tariff increase in August 2015, an inter-ministerial working group was established to develop a new Decree on Energy Vulnerable Customers. By the end of 2015, the government provided additional budget allocation for the program and approved the new decree to enhance coverage and take-up (easing some of the eligibility criteria such as the energy consumption thresholds, the asset test, bill arrears). However, changes in implementation arrangements introduced at the same time (shifting all application processes to local government units) may have led to relatively low numbers of beneficiaries in early 2016, though these have been increasing to date. The DPL series, through Trigger #5, aims to support the government to strengthen further the protection of vulnerable households against rising electricity tariffs. As a lesson learned from the previous decree (2014–2015), the new decree included the second instance body for complaints and redress (Ministry of Mining and Energy) to the beneficiary complaints mechanism.

Gender Dimensions

85. **Some of the impacts discussed are expected to vary by gender.** With respect to rightsizing measures, in EPS and railways companies roughly 80 percent of the labor force are men. In contrast, workers tend to be mostly female in public administration, especially in health (75 percent) and education (71 percent) sectors where the expected staff reductions are among the largest. The National Action Plan for Employment for 2017 will include women over the age of 45 as a priority group for NES activities. Female-headed households (close to a third of households in Serbia), including elderly women living alone, are more vulnerable to the energy price increases. The incidence of electricity poverty in this group is higher than among male-headed households (21.1 percent vs. 16 percent). Strengthening the energy bill discount program as supported by the DPL is important to cushion the impacts, including for female-headed households. The World Bank intends to explore with the Borrower actions which could address the identified gender gaps related to energy price increases. These activities could include better monitoring of the uptake and beneficiary profile (for example, female headed households, elderly women living alone) of the energy bill discount program. In addition, the World Bank intends to engage with the Borrower to analyze, and potentially propose actions, targeting increasing gender balance at EPS.

[46] As detailed in Annex 5, the cumulative electricity tariff increase is simulated to increase the electricity budget share by 0.68 percentage points for the bottom quintile and by 0.52 percentage points for the average due to the combined tariff rise and to increase the share of electricity poor households among the poorest quintile and elderly living alone by 6.3 and 7.0 percentage points, respectively.

5.2 ENVIRONMENTAL ASPECTS

86. **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 have some environmental benefits through improved energy efficiency. Energy and carbon intensity in Serbia are high compared to the other South East 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. Likewise, improvements in operational efficiency in railways and quality of roads are likely to result in fuel savings, thus contributing to improved environmental sustainability.

87. **The overall legal and regulatory framework for addressing the environmental damage and liabilities is deemed adequate, although implementation is frequently hampered by broader institutional and financial capacity constraints.** Serbia has made progress toward alignment of its policies with the EU environmental acquis, and further efforts are needed to strengthen the administrative capacity and implementation framework for management of environmental risks.[47] The Law on Environmental Protection (LEP) establishes the legal framework for environmental protection, and includes provisions for environmental impact assessment, integrated pollution prevention and control (IPPC), nature protection, air, water, soil protection, and waste management which are regulated by separate laws and by-laws.[48] The authorities are preparing a new Law on Environmental Liabilities (LEL), which will transpose the EU Directive 2004/35/EC of 21 April 2004 and is expected to refine and clarify the institutional mechanisms to prioritize and address environmental liabilities. Practices in Serbia vary and are not always consistent with regulatory provisions for environmental protection. The potential indirect impact of rightsizing measures may be through implementation and financial capacity constraints, for example if labor rightsizing impacts government or companies' implementation capacity (Prior Actions 2, 5, 8) or if the new financing framework on rail companies' (Prior Action 7) impacts their financial capacity to address historical and ongoing stock of environmental liabilities. These risks are mitigated by the legal and regulatory framework and by labor rightsizing that prioritizes efficiency improvements and is not across-the-board.

5.3 PFM, DISBURSEMENT, AND AUDITING ASPECTS

88. **The assessment of the country's PFM system in relation to designing disbursement and auditing arrangements for the loan is based on the available diagnostic work in this area in Serbia.** It primarily builds on the 2015 PEFA assessment as well the functional review of the MoF conducted in 2016, relevant chapters of EU Progress Reports, annual SIGMA assessments of public expenditure management and public internal financial control (PIFC), and in-country reports, such as those by the Fiscal Council. Disbursement and auditing arrangements have been determined based on the prevailing fiduciary environment, standard procedures for DPL disbursements and previous experience with similar operations in Serbia.

[47] For further analysis see World Bank (2015). *Serbia - First Programmatic State Owned Enterprises Reform Development Policy Loan Program Project*.

[48] The LEP has a number of provisions concerning environmental liabilities, notably based on the principle of polluters' and legal successors' liability, which stipulate that any legal or natural entity that is involved in activities negatively affecting that is, damaging the natural environment is liable and that the polluter or its legal successor is responsible for eliminating the cause of pollution and related direct or indirect consequences.

89. **As discussed above, a number of reforms have been undertaken aiming to make PFM more efficient, but further improvements are needed.** The Government has undertaken a number of PFM reforms, making efforts to strengthen treasury operations and financial controls, legislative and institutional framework, budget classification and coverage, internal and external audit. These reforms are encouraging, strengthening the transparency, accountability and control framework. However, sizeable challenges remain, as highlighted in the 2015 PEFA Report, and PIFC (including internal audit and financial management and control) still has a long path to cross to respond to EU requirements in the accession process. Nevertheless, the existing inherited system of internal controls is not so weak to represent a major risk for the operation.

90. **Execution of the budget is operated by the Treasury and established processes, controls and procedures provide sufficient assurance about budget execution system**. The Budget is executed for payments through the Consolidated Treasury Account (CTA) operated by the Treasury. Functioning of the CTA is assessed to be reliable with adequate controls instituted, and statements and reconciliations produced on daily basis. Foreign currency funds have not yet been integrated within the CTA, so foreign currency transactions are consolidated in Treasury reports only in certain intervals. Integration of these funds within the CTA is one of the next reform steps and is expected to be implemented by 2016. Payments are done within budget appropriations (defined by either the original or supplementary budget), and hard system controls prevent payments from exceeding annual budget appropriations by a given budget beneficiary. The annual budget is published and available on the internet.[49] In terms of cash and liquidity management, each budget beneficiary is assigned with a payments quota for the coming quarter which is revised every month, and similarly payments exceeding such quotas do not get processed. The Public Procurement Law of 2013 and its amendment in 2015 significantly strengthened the legal framework for public procurement in Serbia, although capacity constraints have undermined implementation.[50]

91. **Financial controls have been gradually strengthened in recent years.** While the PIFC framework has been established by provisions of the Budget System Law, functions of internal audit and financial management and control in practice still require significant development. Internal audit has been established in a majority of public sector entities but further efforts to increase its effectiveness are needed. A financial management and control (FMC) function is yet to be established in a large number of entities and written procedures either do not exist or are not applied in practice. The State Audit Institution (SAI) has come a long way in terms of staffing and coverage of audited public expenditures but further challenges remain in expanding the number of audited entities and responding to broad scope of audits mandated by legislation. The SAI completed the audit of 2014 annual financial statements of the Government (audit of 2015 is ongoing), and issues identified in previous years persist, for example, lack of appropriate systems of internal controls, deficient information on non-financial assets and compliance with the Public Procurement Law.

92. **The control environment and procedures applied in the NBS and the Treasury are considered adequate.** As per the World Bank's assessment of NBS and the Treasury system, the institutional and operational arrangements had been deemed reliable. Based on the assessment, since 2012 designated accounts for all World Bank's loans are opened in the NBS. Annual independent financial audits of the NBS do not identify any significant issues either. The auditors (Deloitte) issued a

[49] See for example, the 2016 Budget Law at http://mfin.gov.rs/pages/article.php?id=11799.
[50] To address these problems, the Government's Procurement Reform Strategy of 2013 identifies priority reforms in three areas: capacity building; process improvements; and performance measurement.

clean (unmodified) opinion on the NBS financial statements for 2014. Audits conducted by the SAI, as well as diagnostic assessments, likewise show that Treasury operating is one of the strengths of the country's PFM system.

93. **This operation is a single-tranche loan to the Republic of Serbia.** The loan proceeds will be made available to the Borrower upon the effectiveness of the Loan Agreement between the World Bank and the Republic of Serbia and compliance with the withdrawal tranche release condition. The loan is included in the Law on Budget for 2016. The proposed loan will follow the World Bank's disbursement procedures for DPLs. Upon approval of the loan and notification by the World Bank of the effectiveness of the Loan Agreement between the World Bank and Republic of Serbia, the Borrower will submit a withdrawal application to the IBRD. The IBRD will deposit the proceeds of the loan into a foreign currency deposit account that forms part of the country's official foreign exchange reserves, designated by the Borrower, to be held at the NBS. This account will be managed by and subject to control of the MoF. The Borrower shall ensure that upon the deposit of the Loan into said account, that it is available to finance budgeted expenditures and the management of public debt, and is accounted for in the budget execution system.

94. **No audit of the deposit account will be required, but rather a confirmation letter to be provided.** The MoF will provide IBRD with written confirmation that the loan proceeds were received in an account of the government that forms part of the country's official foreign exchange reserves, and an equivalent amount has been accounted for in the country's budget management system. This confirmation letter should be delivered within 30 days of the receipt of loan proceeds. No additional arrangements to mitigate fiduciary risks, such as audit, are required as the disbursement arrangements are confined to the NBS and CTA.

95. **In summary, overall fiduciary risk is moderate.** The country's PFM system represents moderate risk to the use of the DPL funds with due economy, effectiveness, efficiency and value for money and fiduciary risk is moderate in relation to the potential impact of fiduciary arrangements negatively impacting the program development objectives (PDOs), which relate to the improved of public expenditures management, but also to improved financial viability and efficiency of transport and energy utilities. The above-mentioned arrangements, provide sufficient safeguard and transparency on the received inflows. On the use of funds, budget execution processes are assessed to be reliable with Financial Management and Control being implemented across the budget beneficiaries as a part of broader PIFC framework.

5.4 MONITORING, EVALUATION, AND ACCOUNTABILITY

96. **The Ministry of Finance will be responsible for overall monitoring and assessment of the implementation of the proposed reform agenda and for coordinating actions with other concerned ministries and agencies.** In addition to the Ministry of Finance, 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. The Ministry of Energy is leading an inter-ministerial working group to monitor the implementation of EPS FCP with a Railway Reform Steering Committee also guiding and monitoring related reforms. The reforms under the DPL are key elements in a range of strategies and action plans with their own results framework and monitoring mechanisms, for example, the broad Economic Reform Program and the Public Administration and PFM Reform Action. Progress on the rightsizing measures is

particularly closely monitored by the government and respective entities, especially in the context of the IMF program discussions, as well as the related PforR operation.

97. **The** World **Bank will monitor the status of the project implementation through supervision missions and tracking results indicators**. The World Bank will track the results indicators provided in the policy and results matrix (Annex I) based on the economic and legislative data provided by the various government agencies and committees and disclosed in official sources. The PforR operation also has a detailed monitoring framework - and disbursement linked indicators – concerning public administration reform measures. This information will be supplemented by regular dialogue and supervision missions through the DPL series. If necessary, results indicators can be revisited during the preparation of the second DPL based on reform progress and additional information available to evaluate the results.

98. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

VI. SUMMARY OF RISKS AND MITIGATION

99. **The overall risk rating of this operation is substantial, as are political and governance risks.** The reforms supported by the DPL series, particularly on rightsizing and financial consolidation in energy and rail, will require strong political will to implement. The 2016 elections returned a coalition government to power which is committed to tackling reforms in the areas of focus of the DPL, as demonstrated by the implementation of key measures in these sectors already. Political and governance risks are also mitigated by the government's overarching strategic objective of Serbia furthering economic integration with the EU which calls for an acceleration of the structural reforms, as well as Serbia's ongoing IMF Standby Arrangement and the program of reforms support by the World Bank. This includes the SOE Reform DPL series which aims to strengthen the governance and institutional framework for public enterprises. Nevertheless, the residual risk is substantial.

100. **Substantial macroeconomic risks remain.** Although recent economic and fiscal performance has been positive, substantial macro-fiscal risks to the PDOs remain. External macro risks relate to Europe's overall economic recovery or adverse shifts in global financial market sentiment while internal risks arise primarily from the high level of public debt, notwithstanding the reduced fiscal deficits, and the rate of progress on crucial but politically difficult reforms, such as public employment rightsizing. A weaker economic environment, particularly if linked to reduced labor market opportunities and income growth, could undermine key reforms, such as on labor rightsizing, and the achievement of the PDOs. However, such reforms are directly supported by IFI programs, including

the IMF program, this DPL series and related World Bank operations, as well as by the EU-monitored national economic reform program, mitigating the risks.

101. **Implementation risks are also substantial.** Implementation of the proposed reforms under the DPL will strain the institutional capacity of respective ministries and public utilities, which are also moving forward on a broader set of reforms. To mitigate these risks, the government has mobilized extensive TA and support from the World Bank, the EU, and other development partners, for example, through this DPL series and the World Bank operations discussed above. This is in addition to support from other partners in these areas, particularly the EU.

102. **Stakeholder risks are rated as substantial.** Tariff reform and reform in energy and transport companies faced strong resistance in the past due to strong power groups (for example, unions) and a lack of confidence that the increased revenues (through higher tariffs) and cost reduction (including labor rightsizing) would benefit the broader population. To mitigate these risks, the operation supports measures aimed at improving transparency and accountability mechanisms. In addition to a strengthened program to protect vulnerable population supported under the DPL series, the Government is also committed to implement communication measures to better inform the broader population on the need for electricity tariff adjustments. There is a high risk that affected employees and more broadly unions in energy and transport companies oppose the rightsizing program. Unions are powerful groups which could pose strong opposition, and eventually, reverse reform. To mitigate this risk, the rightsizing programs in rail and EPS have been discussed with the respective unions, with further consultation through implementation needed.

103. **Social and environmental risks are also substantial:** Notwithstanding the fact that significant adverse environmental impacts are not expected, social and environmental risks are rated as substantial for the above reasons. As highlighted in Section 4.1, the rightsizing and electricity tariff reforms are expected to have potential adverse distributional and social impacts in the short run. While mitigating measures are in place, as detailed in Section 4.1, and the overall poverty impact is expected to be limited, the residual social risk is substantial.

Table 6. Systematic Operations Risk Rating (SORT)

Category	Risk	Rating (H, S, M or L)
1	Political and governance	S
2	Macroeconomic	S
3	Sector strategies and policies	M
4	Technical design of project or program	L
5	Institutional capacity for implementation and sustainability	S
6	Fiduciary	M
7	Environment and social	S
8	Stakeholders	S
9	Other	n/a
	Overall	**S**

Source: World Bank staff.

ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions and Triggers		Results*
Prior Actions under DPO 1	**Triggers for DPO 2**	(End of the calendar year unless otherwise specified)
PILLAR A: PUBLIC EXPENDITURE MANAGEMENT **Program Development Objective A: Improve public expenditure management through strengthened PFM and public administration reform**		
Prior Action #1. The Borrower, through its Ministry of Finance, adopted the framework for monitoring the implementation of the Law on Deadlines for Payments in Commercial Transactions, which has been revised to extend its coverage to include public-public transactions, including those of state-owned enterprises.	(Indicative) Trigger #1. The Borrower, through its Ministry of Finance (a) puts in place a central register of invoices for public-public transaction and (b) enforces payment deadlines for said transactions.	Results Indicator A1 – Increased percentage of invoices for public to public commercial transactions recorded in the central register: • Baseline (end-2015): 0 percent • Target (end-2018): 100 percent
Prior Action #2. The Borrower: (a) adopted the Law on the Ceiling on Public Sector Employees setting the criteria of determining the maximum number of employees in the public sector, from 2015 to 2018, as well as the scope and limits for reducing their number in order to achieve the established said maximum; and (b) established, as required by said law, the first institution-level limits on the number of employees in the public sector.	(Indicative) Trigger #2. Based on the Law on the Ceiling on Public Sector Employees, the Borrower has in 2017 set out updated institution-level limits on employees in the public sector, as determined by the Law.	Results Indicator A2 - The number of employees in the public sector, as determined by the Law on the Ceiling on Public Sector Employees, does not exceed the total of institutional-level limits set under the Law and its decisions: • Baseline (end-2015): no • Target (end-2018): yes
Prior Action #3. The Borrower adopted the Law on the Salary System of Public Sector Employees to rationalize the public sector pay structure.	(Indicative) Trigger #3. The Borrower, through its government, maps all employees within the education, health and social protection sectors to the new grades set out in the Public Sector Job Catalogue.	Results Indicator A3 - Increased share of employees within the education, health and social protection sectors paid on the basis of their new grades set out in the Public Sector Job Catalogue: • Baseline (end-2015): zero • Target (end-2018): 60 percent

Prior actions and Triggers		Results*
Prior Actions under DPO 1	**Triggers for DPO 2**	(End of the calendar year unless otherwise specified)
PILLAR B: ENERGY PUBLIC ENTERPRISES **Program Development Objective B: Improve the financial sustainability and efficiency of energy sector public enterprises**		
Prior Action #4. The Borrower: (a) through its Council of the Energy Agency, approved a 3.8 percent increase of the electricity tariff for guaranteed supply; (b) amended the Energy Vulnerable Customers Program to increase coverage of targeted beneficiaries; and, (c) increased the budget for said program.	(Indicative) Trigger #4. The Borrower: (a) through the Council of the Energy Agency, approves an additional increase of the electricity tariff for guaranteed supply in 2017; and (b) takes measures, if necessary, to protect vulnerable households.	Results Indicator B1 - Increased convergence of the guaranteed electricity supply tariff to reach market parity levels: • Baseline (end-2014): 64 percent • Target (end-2018): 80 percent Results Indicator B2 - Increased number of total beneficiaries of the Energy Vulnerable Program: • Baseline (2014 annual): 60,600 households; of which 27 percent female headed households • Target (2018 annual): 90,000 households; of which 30 percent female headed households
Prior Action #5. The Borrower, through the Supervisory Board of *Elektroprivreda Srbije* (EPS): (a) adopted a labor optimization plan for 2016-2019 setting out the medium-term targets, process, compensation packages, selection criteria, grievance mechanisms and timeline for reductions in staffing; and (b) issued the first call for voluntary separations to implement the 2016 target for net staff reduction.	(Indicative) Trigger #5. The Borrower, through the Supervisory Board of EPS, implements the labor rightsizing in 2016 and 2017 in accordance with the EPS Labor Optimization Plan.	Results Indicator B3 - Reduction in annual EPS wage bill relative to 2014: • Baseline (2015): zero • Target (2018): 10 percent
Prior Action #6. The Borrower adopted a financial consolidation plan for *Srbijagas* that defines measures to increase revenues and reduce costs.	(Indicative) Trigger #6. The Borrower improves *Srbijagas* financial management through: (a) implementation of the policy for gas supply interruption based on the government adoption of a conclusion defining the mechanisms to discontinue gas supplies to commercial consumers in arrears; (b) the Ministry of Energy and Mining issues an opinion on an investment appraisal methodology as adopted by the management of Srbijagas; and, (c) the *Srbijagas* audit committee documents its activities as the body in charge of the oversight of the system of internal controls, internal audit, and external audit.	Results Indicator B4 - Increase in *Srbijagas*' collection rate of current receivables: • Baseline (2015): 80 percent • Target (average 2016-2018): 87 percent Results Indicator B5 - The approved *Srbijagas* 10-year development plan for the Gas Transport System Operator and 5-year development plan for the Distribution System Operator are in accordance with the adopted economic and financial appraisal methodology: • Baseline (2016): No • Target (2018): Yes

<table>
<tr><th colspan="2">Prior actions and Triggers</th><th>Results*</th></tr>
<tr><th>Prior Actions under DPO 1</th><th>Triggers for DPO 2</th><th>(End of the calendar year unless otherwise specified)</th></tr>
<tr><td colspan="3">PILLAR C: TRANSPORT PUBLIC ENTERPRISES AND STATE-OWNED COMPANIES
Program Development Objective C: Improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies</td></tr>
<tr><td>Prior Action #7. The Borrower: (a) implemented a new framework for railways financing through conclusion of the track access contracts between the state-owned infrastructure rail company and the state-owned freight and passenger rail companies and approving a public service obligation agreement; and (b) adopted new performance criteria for the state-owned infrastructure, freight and passenger rail companies.</td><td>(Indicative) Trigger #7. The Borrower: (a) through the respective railways operating companies, approves and initiates the implementation of a plan to restructure their commercial debt in a manner that places the companies in a position to be financially viable; and (b) through the management of the respective railway companies, makes publicly available the annual financial statements of the new railways companies prepared under IFRS, as required under the Law on Accounting, and modernizes their financial and accounting systems to allow effective implementation of IFRS.</td><td>Results Indicator C1 - Level of annual direct budget operational support to the Railways Companies:
• Baseline (2015): RSD 13.5 billion
• Target (2018): RSD 11 billion
Indicator C2 - Improvements in labor productivity (measured by train kilometers per employee) and in asset utilization (measured by passengers per kilometer of track and ton per kilometer of track) relative to 2014:
• Baseline (2015): zero
• Target (2018): 15 percent (for both indicators)</td></tr>
<tr><td>Prior Action #8. The Borrower: (a) through the Decisions of the General Assemblies of the respective railway companies, adopted labor optimization plans for 2016-2020 setting out the medium-term targets, process, compensation packages, selection criteria, grievance mechanisms and timeline for reductions in staffing; and (b) through the management of the respective railways companies, initiated the 2016 target for staff reduction by communicating to the companies' respective employees the option for their participation.</td><td>(Indicative) Trigger #8. The Borrower, through the General Assemblies of the respective railways companies, implements labor rightsizing in 2016 and in 2017 in accordance with their respective Labor Optimization Plans.</td><td>Results Indicator C3 - Reduction in annual wage bill of railways companies relative to 2015:
• Baseline (2015): zero
• Target (2018): 25 percent</td></tr>
<tr><td></td><td>(Indicative) Trigger #9. The Borrower, through its government, prepares a framework service-level agreement with PERS defining standards for different road classes, committing to provide the agreed financing for roads and holding PERS accountable for service delivery.</td><td>Results Indicator C4 - The government agrees with Roads of Serbia on maintenance levels for the different road classes with associated guaranteed funding levels committed:
• Baseline (for 2016 budget): no
• Target (for 2019 budget): yes</td></tr>
</table>

Note: * Additional information on the results indicators is provided in the respective discussions in Section 4.2.

MINISTRY OF FINANCE

Dr. Jim Yong Kim

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Belgrade, November 23, 2016

REF: Letter of Development Policy

First Public Expenditure and Public Utilities Development Policy Loan

This letter summarizes in a selective manner critical aspects of the program that the Government of Serbia is committed to undertake over the short and medium term to support a multi-year fiscal consolidation agenda and transformation of energy and transport sector public enterprises and State-Owned Enterprises (SOEs). This includes measures to improve public expenditure management through strengthened public financial management and public administration reform, improve the financial sustainability and efficiency of energy sector public enterprises, and improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies.

This program supports the objectives of economic policy set by the Government's 2016-2018 Fiscal Strategy and its 2016-2018 Economic Reform Program[1], and the Memorandum of Economic and Financial Policies, agreed with the IMF. A credible medium-term plan of structural reforms, together with measures of fiscal consolidation, is a key basis for (1) achieving stabilization of public finances by reducing the fiscal deficit and public debt, (2) faster economic growth based on the increase in investments, exports and employment.

Macroeconomic framework and key structural reforms

The Government of Serbia adopted on November 28th 2015 the *Fiscal Strategy for 2016–2018,* which outlines our economic policy for the medium-term. The main goals of our economic policy are: continuation of the fiscal consolidation measures to ensure macroeconomic stability, curb the growth of public debt and put it on a downward path; increasing the stability and resilience of the financial sector, including by resolving the issue of non-performing loans; continue implementing a comprehensive set of structural reforms to improve competitiveness and ensure sustainable economic growth, in particular

[1] Including the preliminary list of structural reforms to be included in the ERP 2017-19 which was put for public consultations in October 2016.

through the reforms of the state owned enterprises and improving the efficiency of the public sector. The goals of the economic program are compatible with our aspirations to become an EU member, having started the accession negotiations process in December 2015.

Over the medium-term, growth is expected to accelerate to average of 3.3 percent, inflation is expected to stay within the NBS target band, and the balance of payments is foreseen to further improve. To reduce the fiscal deficit and public debt, we are implementing an ambitious plan for fiscal consolidation and structural reforms under the ongoing three year IMF Stand-by Arrangement (SBA). The IMF SBA was approved in February 2015, and the fourth and fifth review were successfully completed and endorsed by the IMF Board in August 2016. The sixth review was completed in November 2016 and we reached a staff level agreement while the full endorsement is expected at the IMF's Board meeting in early December. The program is supporting the necessary fiscal adjustment, while at the same we are working on the design and implementation of various structural reforms with the World Bank and other IFIs. We will implement those reforms in order to foster growth, improve competitiveness, and increase exports and investment across the economy. Furthermore, we expect that the improved global economic outlook and gradually that of the EU will positively impact economic activity and employment in Serbia, as the EU is Serbia's main trading partner and source of FDI.

Serbia's economy was hit hard by the international financial crisis which started in late 2008 as well natural disasters in more recent years. As a result, our economy contracted three times in the period 2009-2014. It is important to stress that recessions in 2012 and 2014 were primarily caused by natural disasters – a drought in 2012 and severe floods in 2014. In addition, weak recovery of our main trading partners and economies from the region as well as internal structural bottlenecks prevented the economy from recovering more rapidly. However, the growth model for Serbian economy has gradually changed – from one driven by domestic demand towards export-led growth. Thus share of exports in GDP increased from 29 to 47 percent between 2008 and 2015.

Supported by the post-flood recovery of industrial production, growth recovered over 2015 to reach 0.8 percent (in real terms). Investment and exports were the main drivers of growth. The recent recovery in activity has been reflected in improved labor market outcomes. According to the Labor Force Survey data for Q2 2016, the employment rate has reached 45.9 percent, an improvement of 3.3 percentage points compared to the same quarter last year (42.6 percent). The unemployment rate is 15.2 percent, an improvement of 2.1 percentage points compared to the same quarter last year (17.3). Inflationary pressures have been limited by relatively weak domestic demand, lower oil import prices and, until August 2015, the absence of adjustments of administratively controlled prices. Inflation reached 1.5 percent y/y in October 2016. The financial system is broadly stable. The NBS is working on the resolution of the longstanding problem of non-performing loans (NPLs) under the new Action Plan for NPLs resolution (approved in August 2015). As a result, NPLs went down by 2.6 percentage points over the previous twelve months.

We expect stronger economic recovery from 2016 and onwards. Due to supportive external demand, improved investment, and gradual recovery of consumption, we project growth to move up to around 3.5 percent after 2017. Fiscal consolidation measures turned out to be less recessionary than expected. Originally projected decline of GDP by 0.5 percent in 2015 was revised to positive growth, according to the final SORS data at 0.8 percent. This turnaround was due to a positive private sector response in both investment and wage growth which more than compensated for the reduction in pensions and public sector wages. The positive effects are expected to carry over into 2016-2017 with higher GDP growth rates now projected at 2.7 and 3.0 percent respectively. Anchored in structural reforms, significant investment revival is forecast over the IMF program period (i.e. through 2018): investment is set to rise above 20 percent of GDP. The improved external environment will also support a narrowing of the current account deficit, from 6 percent of GDP in 2014 to about 3.9 percent of GDP in the medium run, fully financed by FDI. Improved growth performance will gradually bring further improvements in labor demand and employment expansion, thus contributing to poverty reduction and shared prosperity.

Over the medium-term, we envisage a continued significant fiscal adjustment supported by the IMF program. Fiscal vulnerabilities experienced over the 2012-2014 period led to the build-up of public debt to 72 percent of GDP at the end of 2014. The Government put in place a fiscal consolidation program which has contributed to improved fiscal performance in 2015. The augmented fiscal deficit of the general government was reduced from 6.6 percent of GDP in 2014 to 3.7 percent in 2015, compared to a 5.9 percent target set in the IMF supported program. This impressive result in the first program year was associated with an even more important 2.6 percent structural deficit improvement which sets Serbia on a sustainable deficit reduction path towards targets set in the program. These results are expected to reverse the growing trend of the public debt and put it on a decline path after 2016.

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

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

- The Labor Law adopted during the summer of 2014, which increases flexibility of the labor market in Serbia, by making it easier and cheaper to hire and fire workers.
- The Law on Construction and Planning, adopted in early 2015, which will significantly streamline issuance of construction permits, a major bottleneck in Serbia's investment climate. A New Law on Land Conversion was adopted in 2015. Proper implementation of these two laws will address most of the major concerns related to land use, administration and management.
- A new umbrella Law on Inspections was adopted in April 2015. The law will improve coordination of inspections, increase predictability and transparency of their work, and put more emphasis on risk based approach to inspections.
- The Law on Privatization, adopted during the summer of 2014, to introduce more flexibility for the remaining privatizations.
- Amendments to the Law on Bankruptcy, adopted during the summer of 2014, to set clearer rules and streamline procedures.
- Introduction of across the board e-payments of taxes, significantly easing the administrative burden on enterprises.

- As discussed below, we are progressing with reforms of the general government employment and wage system.
- During 2014, the Law on Pension and Disability Insurance was amended, including the following: (1) increasing the legal age of retirement for women from 60 to 65 years until 2032 (6 months per year until 2020, 2 months per year thereafter); (2) increase the minimum retirement age from 58 to 60 years by 2023, and (3) the introduction of a penalty of 4% per annum for early retirement.

Macroeconomic and fiscal developments in the first half of 2016 were better than expected. As a result, projections of real GDP growth are revised upwards to 2.7 percent in 2016 and to 3.0 percent in 2017. Macroeconomic performance affected the fiscal position as revenue collection is significantly better than planned, which will reduce general government deficit to around 2.1 percent of GDP. A primary fiscal surplus will be achieved in 2016 already. Structural fiscal adjustment in previous years, combined with favorable macroeconomic outlook, will significantly improve the fiscal position in the upcoming period with a faster reduction of public debt and deficit levels. A new macroeconomic and fiscal medium term framework will be presented in Fiscal strategy for 2017 with projections for 2018 and 2019 which will be adopted in December 2016, along with the budget for 2017.

Program of Reforms on Public Expenditure and Public Utilities

The government is committed to transforming Serbia into a fully functioning market economy with a vibrant private sector. As set out in the Fiscal Strategy 2016-2018, this includes structural reforms focusing on the real and public sector respectively.

Through ongoing reforms, and the support of this Public Expenditure and Public Utilities DPL series and related operations, the Government and the Ministry of Finance is committed to improving the management of public finance and moving forward with public administration reform to reduce expenditure on employees through addressing the number and structure of employees in the government sector and reform of the system of salaries. We are also committed to taking measures to ensure financial sustainability of energy companies and improving the efficiency in public transport companies, helping to support reductions in budget support to public and state-owned enterprises.

This DPL series complements the programmatic SOE DPL Series which aims to improve the governance, transparency and accountability of SOEs that will remain in government ownership, restructure and divest from non-competitive enterprises, reduce the fiscal burden imposed by the commercial 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. It also complements other recently operations with the World Bank and other partners, including the WB Competitiveness and Jobs Project and the Program-for-Results (PfR) operation on Modernization and Optimization of Public Administration.

Improve public expenditure management

i) Strengthened public financial management

The objective of the recently adopted Program of Public Finance Management Reform (PFMR) from 2016 to 2020 is to provide a comprehensive and integrated framework for the planning, coordination, implementation and monitoring of progress in the implementation of sustainable activities so as to improve macroeconomic stability, ensure efficient and purposeful deployment and use of public resources for the realization of the national priorities and improve the services provided by the government administration in the Republic of Serbia, while increasing transparency and the overall functionality of the public finance management and fulfilment of the necessary conditions for accession to the European Union (EU).

In order to strengthen financial discipline in the public sector, the effect of the Law on Payment Deadlines in Commercial Transactions (often referred to as the RINO Law) was extended by amendments to the Law in July 2015, so that it also applies to transactions among public sector institutions. Amended provisions of the Law apply as of 1 January 2016, with monitoring mechanisms set out in a Rulebook adopted in October 2015. The Law establishes monitoring and control mechanisms of applying the provisions relating to payments between units of the public sector. The mechanisms that enable consistent implementation of the Law relate to, among other things, reduction in transfers from the budget, where the measure may be applied, or in case that the state-owned or public enterprise receives some form of support from the budget, as well as penalties for the responsible persons determined in accordance with the Law. The Rulebook regulates how the supervision over the implementation of the law will be conducted by the Budget Inspection Unit of the Ministry of Finance for transactions which involve public sector entities. The rulebook on supervision of the implementation of the RINO law is enforced as the Budget Inspection Unit collects data from the relevant Treasury systems, analyzes them and takes concrete steps. However, the full positive impact of the RINO Law and accompanying by-laws is subject to further constraints, such as unconfirmed accuracy and completeness of reported data by public sector entities, within three days of incurring the commitment as prescribed by legislation. Improved reporting discipline as the implementation period is longer and the sanctions and on-site visits of the Budget Inspection are applied to larger number of entities is expected to help address this issue. In addition, supplemental steps could lead to the solution of the issues, such as additional features in the FMIS not allowing executing payments for untimely recorded commitments, additional secondary legislation ensuring accuracy and timeliness of reporting on outstanding commitments and arrears by users of public funds, raising awareness training for the users of public funds etc. Accurate information on commitments and arrears is vital for the credibility of budget formulation and budget execution processes. We will also establish a new e-invoice system covering the public sector based on a unique invoice code that would be required at the time of invoicing.

ii) Public administration reform

Public administration reform is one of the main elements of structural reforms to achieve long-term sustainability of public finance and establish a sound business environment. This includes measures to reach the objective of the fiscal policy in the medium term is to reduce expenditures for employees on a sustainable level of 7% of GDP, as defined by the Law on Budget System.

To ensure better organization of public administration and improve the quality of services, while also supporting fiscal consolidation, progress has been made on the labor rightsizing process. The Law on the Ceiling on Public Sector Employees, which was adopted in July 2015 is a legal basis for the manner of determining the maximum number of public sector employees in the public sector, from 2015 to 2018, as well as the scope and limits of reducing the number of employees in order to achieve the established maximum number of employees in the public sector determined by this Law, in line with the expected improvement of their productivity to which should come after the reorganization. The Decision on the Maximum Number of Public Sector Employees for 2015, was passed by the Government on 2 December 2015. As of end-September 2016, public sector employment (including local public utilities) has been reduced by about 22,000, compared to the end-2014 level, mostly through attrition. More recently available data indicates that employment has continued to decline. While generally applying the 5:1 attrition rule through 2016 for the public sector, our attention is now turning to detailed systemization plans and identifying fiscal space at the institutional level available for future hiring. An optimisation and modernisation process is being carried out through conducting vertical and horizontal functional analyses, in collaboration with the World Bank, defining recommendations for reorganisation and modernisation to increase the efficiency and quality of public services and the development of a time-bound Action Plans for implementation of the recommendations. Drawing on this work, by end-March 2017, we will adopt decisions under the Law on Ceiling on the Public Sector Employees setting the next set of detailed limits on positions for each institutions of the general government (excluding the Ministry of Defense) and local utility companies.

There is also a need to reform the system of salaries in the government sector in order to reduce inequalities in salaries, and creating equity through introduction of the principle of equal pay for equal work. Activities are currently underway to develop a uniform regulatory framework for the salary system in public administration through the establishment of a coordinated salary system based on the principles of transparency, fairness and "equal pay for work of equal value." The umbrella Law on the Salary System of Public Sector Employees in the came into force on 9 March 2016. The Law envisages a unified base for all wages and a simplified structure of coefficients and pay elements (supported by a new decree on coefficients to be adopted in December 2016), but allows for sufficient flexibility in specific sectors. Special laws must be enacted to regulate in detail the salaries and other emoluments of employees in public services, state authorities, authorities of autonomous provinces and local self-government units and public agencies. In parallel, an extensive process of developing a Catalogue of Job Posts in the Public Sector is underway in order to catalogue and describe all jobs in the entire public sector. A third draft of the Catalogue is expected to be developed during the next period. Once the Catalogue has been developed, it will be possible to progress to the next stage, in which all public sector jobs will be evaluated in order to determine their interrelations and then to payment of employees on the basis of the new grades.

Improve the financial sustainability and efficiency of energy sector public enterprises, in particular Elektroprivreda Srbije – EPS (Serbia's national electric power utility) and JP Srbijagas

As part of the reform of public enterprises, we plan to restructure large systems in transportation and energy sectors, directing them towards market principles of operation, namely: JP EPS "Electric Power Industry of Serbia", JP "Srbijagas" and "Serbian Railways". At the proposal of relevant ministries the government has adopted programs of corporate restructuring of these large systems in order to improve their organizational structure and management system, as well as reducing the negative impact on public finances and the rest of the economy

In July 2015, the Plan of Corporate Restructuring for PE EPS was adopted with focus on simplifying the organizational structure and management and rationalization of the number of employees in order to avoid the need for state aid in the future. In June 2015, a Financial Consolidation Plan was adopted, which was prepared in cooperation with the World Bank and the European Bank for Reconstruction and Development (EBRD), with the goal to create a profitable company capable of responding to market challenges in terms of both quality and price. The basic elements of the Plan are as follows: increase in revenues through improved collection and decrease in costs through increased efficiency, optimization of the procurement process and reducing the number of employees. Following a household tariff increase of 4.5 percent in August 2015, another increase of 3.8 percent will be effective from October 2016, to reduce the financing gap and narrow the difference between domestic and regional market levels. We have also taken steps to support households impacted by higher energy prices, adopting a new Decree on Energy Vulnerable Customer in December 2015 and increasing the budget allocation for the program in 2016 to RSD 1.65 billion, up RSD 680 million in 2015. We will continue to analyze progress in the implementation of other measures in the FCP and regional electricity prices, with this analysis informing future electricity tariff increases.

Consistent with the five-year rightsizing target specified in the financial restructuring plan, the EPS supervisory board has adopted in August 2016, in consultation with the World Bank, a credible 2016-19 labor optimization plan targeting a reduction in labor costs by end-2019 of 15 percent compared with 2015 levels. This plan will be carried out in order to achieve social sustainability of the employee downsizing model and, together with broader social protection systems and labor policies implemented by the government, is expected to mitigate negative social impacts. Implementation of the labor rightsizing is ongoing and by end-October 2016, about 1,900 employees had voluntarily applied for the severance package. We are committed to continuing the program of labor rightsizing to deliver on the targets of the optimization plan and support the financial sustainability and efficiency of EPS.

PE "Srbijagas" has been a significant source of fiscal risk primarily through its high levels of debt, almost all of which have a government guarantee. A new organizational restructuring plan for the company, adopted in December 2014, started to be implemented in June 2015. The plan includes the sale of assets that are not used for performing basic activity and resolving collection of receivables from the largest debtors, including enterprises: HIP Azotara Fertilizer Co, HIP Petrohemija and MSK Kikinda. A financial consolidation plan, prepared with the support of the World Bank, was adopted for Srbijagas in March 2016, with the emphasis on measures for achieving long-term financial sustainability and competitiveness. Payment discipline has improved following the adoption of the financial consolidation plan for Srbijagas in March.

To lower the fiscal cost associated with servicing Srbijagas' commercial loans, we are finalizing a debt restructuring plan aimed at refinancing existing liabilities at more favorable terms. In order to stop Srbijagas from accumulating arrears going forward and improve collections, a government conclusion is under preparation which has the goal to ensure follow-through on the company's disconnection policy for commercial consumers in arrears. To further stabilize Srbijagas financial situation, we will conduct a legal and economic review of the investment plan of the company with the objective to rationalize CAPEX spending and the Ministry of Mining and Energy will issue an opinion on an investment appraisal methodology, prepared by the management, for assessment of medium-term transportation and distribution capital expenditure plans. We are also conducting a diagnostic of the gas distribution sector to address the fragmentation in the sector and identify options for how to achieve greater efficiency and economies of scale. These measures will improve Srbijagas' financial position and put the company on a sustainable path, thus containing the need for additional state aid.

In order to improve corporate governance of the company, Srbijagas will during the first half of 2017 establish and make functional an audit committee in line with the requirements of the Law on Public Enterprises. The audit committee is expected to enhance company's risk management, financial reporting, applied system of internal controls, internal and external audit.

Improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies

In order to improve the railway network and the overall rail transport service, as well as to limit budgetary support to SOEs, it is of primary importance to reorganise the Public Enterprise Železnice Srbije (Serbian Railways) in accordance with the principles of efficient and sustainable operation.

To this end, we established a Railway Reform Steering Committee, led by the Deputy Prime Minister and including senior representatives from relevant Ministries and entities, IFIs, and EU, to provide overall direction of the reforms. The unbundling of the company into separate passenger, freight, infrastructure, and a fourth company, became effective from August 2015. The corporate restructuring plan is centered on asset disposal, network re-optimization, and staff rationalization. Importantly, the freight section has received no further subsidies and has operated on a purely commercial basis from January 2016.

To support market competition, we have adopted all the necessary acts in order to allow network access to private operators in February 2016, and the first contract with a private operator was signed in June 2016. The contractual relationships and financial policies of the new system (between the state and the companies and across the companies) have been set out. This includes track access contracts between the railway companies, the Multi-Annual Infrastructure Contract and the Public Service Obligation Contract which were adopted by the Government in January 2016 and signed in February 2016. When it comes to the description of new performance criteria, the PSO contract for the first time in the Republic of Serbia introduced responsibilities of the railway passenger operator (regarding the specification of the rolling stock, personnel, regularity of railway transport on PSO lines, safety measures etc.) with specified measures if the same were not fulfilled. In accordance with the Multi-Annual Infrastructure Contract, the rights and obligations of the infrastructure and the Government are regulated, including the sanctions for breach of the contract. Also, this contract governs financing costs of managing the public railway infrastructure, but actually defines the amount needed for maintenance of the railway infrastructure and the organization and regulation of rail transport, providing access for usage of the railway infrastructure to all interested parties, providing telecommunication services as well as services of electricity transmission in connection with traffic on railway and defines the key performance indicators. The business plans of the operating railways companies also contain new key performance indicators to support improved accountability and performance management.

We will also continue the reorganization and improvement of business plans for the state-owned passenger and infrastructure companies and the fourth company, to strictly limit the amount of state aid disbursed over the medium term. We are implementing the Railway Reform Plan (2016-2020) which was adopted in October 2015 and developed in consultation with the World Bank, EBRD and EU. The Railways Reform Steering Committee adopted a conclusion in June 2016 (end-March structural benchmark) which defines the rightsizing targets for 2016 (2,700 staff positions). The General Assemblies of the four companies adopted in early September and October 2016 the Labor Optimization plans setting out the process and targets for reducing staffing levels, as well as the compensation packages and for redundant employees, selection criteria and timeline, with the plans updated in November 2016. The companies have been moving forward with the next steps in the labor optimization process including surveying employees and preparing Retrenchment Programs. By October 24, 2016, employees expressing interest in taking a severance package had reached around 65 percent of the 2016 targeted numbers for staff reduction. We also intend to move forward in other areas to ensure that the new operating companies are able to operate from a solid financial starting point include addressing the burden of the historical commercial debt of the companies and moving forward with development of improved financial and accounting systems.

Reform of PERS (Roads of Serbia) will be organized in cooperation with the World Bank. The negotiations for the additional funding of EUR 35 million and for the closing date extension to June 30, 2018 for the Corridor X Highway Project have been completed and the Board date is scheduled for October 25, 2016. As part of additional financing, Component 3 : "Implementation Assistance and Institutional Support" will be increased to grant EUR 3 million for technical assistance to the reform of the PE "Roads of Serbia". The corporate and financial restructuring plans for Roads of Serbia will look at the expenditure and revenue side and corporate structure of Roads of Serbia, but will also provide recommendations for improvement of the current practices and knowledge in the sector. This includes, but is not limited to, adopting a plan for removing rigidities in pricing maintenance contracts and introduction of performance based contracting on 1500km of network, revision of the adequacy of the toll rates, recommendations regarding design standard and practices, etc. Reform of the Roads is planned to be launched by the end of 2016.

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, across the above areas, and particularly also for the resolution of commercial SOEs. 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. Support to the National Employment Service in the efforts to strengthen its capacity and improve services for the unemployed is being provided by the World Bank (including through results-based financing loan on Competitiveness and Jobs) and other partners, like the EU. Last but not the least, as envisaged by the 2016-2018 Economic Reform Program adopted by the Government and presented to the European Commission, we will improve the adequacy of financial social assistance by linking the different sectors' information systems to ensure that clients have access to their social rights without administrative barriers and that the overall social assistance is better targeted. To this end we are preparing a new Law of Social Protection which will replace the existing legislations that governs the eligibility and conditions to receive social assistance.

Sincerely,

Dušan Vujović

Minister of Finance

Republic of Serbia

ANNEX 3: FUND RELATIONS ANNEX

IMF Executive Board Completes the Sixth Review of Serbia's Stand-By Arrangement

Press Release No. 16/563, December 16, 2016

- The economy continues to strengthen, supported by the authorities' efforts
- Significant progress has been made on fiscal consolidation in 2016
- Serbia achieved notable improvement in business environment, but more needs to be done

The Executive Board of the International Monetary Fund (IMF) on December 16, 2016 completed the sixth review of Serbia's economic performance under the Stand-By Arrangement (SBA). The completion of the review will make available the cumulative amount of SDR 662.575 million (about €850.8 million). The Serbian authorities have indicated their intention to continue treating the arrangement as precautionary.

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

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

"The Fund-supported program is delivering positive results, underpinning macroeconomic management and structural reforms in Serbia. The economy continues to strengthen, supported by the authorities' efforts to improve public finances, address structural weaknesses, and strengthen the financial sector. Employment is rising, inflation remains firmly under control, and public debt has started to decline. Full implementation and strong ownership of the reform agenda are critical to consolidate hard-won gains, improve the business climate, and support Serbia's medium-term growth.

"Significant progress has been made on fiscal consolidation in 2016, on account of strong revenue and ongoing expenditure control. Institutional reforms aim to secure fiscal sustainability and improve public services. Priorities include eliminating domestic arrears, reforming the public administration and wage system, and strengthening public investment management. Further efforts are also needed to minimize fiscal risks through a restructuring of unviable state-owned enterprises, especially in the mining, energy, and transportation sectors, while enhancing social safety nets. The authorities are taking steps to strengthen public project appraisal and implementation, and modernize the educational system.

"The reduction in the inflation target reflects improved macroeconomic fundamentals and market confidence. The lower target should support the dinarization strategy and help reduce long-term interest rates. The current cautiously accommodative monetary policy stance remains consistent with the new target.

"Financial sector reforms have strengthened the resilience of the sector. The strategy for resolving nonperforming loans has helped reduce the overall bad loan ratio, and the authorities remain committed to its full implementation, especially with respect to state-owned banks.

“Serbia has achieved notable improvement in the business environment, but more needs to be done to boost investor confidence and medium-term potential growth. Particular efforts should be made to improve the court system, strengthen the quality of the judiciary process, and facilitate the use of effective out-of-court arbitration.”

http://www.imf.org/en/News/Articles/2016/12/16/PR16563-Serbia-IMF-Executive-Board-Completes-the-Sixth-Review-of-Stand-By-Arrangement

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant positive or negative environment effects (yes/no/to be determined)	Significant poverty, social or distributional effects positive or negative (yes/no/to be determined)
PILLAR A: PUBLIC EXPENDITURE MANAGEMENT Program Development Objective A: Improve public expenditure management through strengthened PFM and public administration reform		
Prior Action #1: The Borrower, through its Ministry of Finance, adopted the framework for monitoring the implementation of the Law on Deadlines for Payments in Commercial Transactions, which has been revised to extend its coverage to include public-public transactions, including those of state-owned enterprises.	No	No
Prior action #2: The Borrower: (a) adopted the Law on the Ceiling on Public Sector Employees setting the criteria of determining the maximum number of employees in the public sector, from 2015 to 2018, as well as the scope and limits for reducing their number in order to achieve the established said maximum; and (b) established, as required by said law, the first institution-level limits on the number of employees in the public sector.	No	Yes, negative
Prior action #3: The Borrower adopted the Law on the Salary System of Public Sector Employees to rationalize the public sector pay structure.	No	No
PILLAR B: ENERGY PUBLIC ENTERPRISES Program Development Objective B: Improve the financial sustainability and efficiency of energy sector public enterprises		
Prior action #4: The Borrower: (a) through its Council of the Energy Agency, approved a 3.8 percent increase of the electricity tariff for guaranteed supply; (b) amended the Energy Vulnerable Customers Program to increase coverage of targeted beneficiaries; and, (c) increased the budget for said program.	Yes, positive	Yes, negative
Prior action #5: The Borrower, through the Supervisory Board of Elektroprivreda Srbije (EPS): (a) adopted a labor optimization plan for 2016-2019 setting out the medium-term targets, process, compensation packages, selection criteria, grievance mechanisms and timeline for reductions in staffing; and (b) issued the first call for voluntary separations to implement the 2016 target for net staff reduction.	No	Yes, negative
Prior action #6: The Borrower adopted a financial consolidation plan for Srbijagas that defines measures to increase revenues and reduce costs.	No	No
PILLAR C: PUBLIC TRANSPORT COMPANIES Program Development Objective C: Improve the financial sustainability and efficiency of transport sector public enterprises and state-owned companies		
Prior action #7: The Borrower: (a) implemented a new framework for railways financing through conclusion of the track access contracts between the state-owned infrastructure rail company and the state-owned freight and passenger rail companies and approving a public service obligation agreement; and (b) adopted new performance criteria for the state-owned infrastructure, freight and passenger rail companies.	No	No
Prior action #8: The Borrower: (a) through the Decisions of the General Assemblies of the respective railway companies, adopted labor optimization plans for 2016-2020 setting out the medium-term targets, process, compensation packages, selection criteria, grievance mechanisms and timeline for reductions in staffing; and (b) through the management of the respective railways companies, initiated the 2016 target for staff reduction by communicating to the companies' respective employees the option for their participation.	No	Yes, negative

ANNEX 5: ADDITIONAL ANALYSIS OF POVERTY AND SOCIAL IMPACT

1. **This annex provides additional information on the potential poverty and social impact of the DPL prior actions.** It focuses on quantitative analysis of the prior actions relating to labor rightsizing in EPS, the railways companies and public administration and the electricity tariffs adjustments. Discussion of mitigating measures and the overall PSIA is provided in Section 5.1.

Poverty and Social Impacts of Labor Rightsizing in EPS, Railways Companies and Public Administration

2. **Public workers potentially affected by the labor rightsizing in the public administration, EPS and railways companies are not the most vulnerable groups in Serbia's population.** An analysis based on the companies administrative records and household surveys show that overall poverty impacts would be limited, especially in the short run, since the potentially affected public workers are not the most vulnerable population.[51] Workers in public administration, EPS and public railway companies, as a whole, are older and more educated than in the formal and informal private sector. Salaries are higher than in similar positions in the private sector, especially in EPS. They are in a better position than former SOE workers from the PA companies, which were rationalized in their vast majority a few years ago. However, although rightsizing in the public sector has received considerable public awareness in recent years, preparation of workers in advance for the possibility of losing their employment may be lower, on account of the stability of employment enjoyed until very recently (in contrast, most PA companies liquidated a few years ago were carrying arrears in their salaries and many companies were de-facto liquidated before formally laying off workers).[52] In terms of welfare, workers from the three affected groups are not poor nor in a particular vulnerable position, though workers in transport are slightly less well-positioned. In general, the workers tend to be located in the mid to top quintiles of the distribution, and other vulnerability indicators (for example, single earners, household composition, health status) seem to be consistent with what is observed among formal private sector workers and better than the informal sector (Table 5.1).

3. **Nonetheless, it is still important to acknowledge that workforce rationalization will have an important social cost on wellbeing of the retrenched workers and their families, and previous experiences indicate that it is very difficult for them to find new permanent positions.** The immediate loss of a significant income source from public wages, unless compensated with a fair severance package, would imply a negative shock to household income in those families. More than a third of public workers report to be the only employed person in the household, and particularly for transport workers, a significantly higher share relies on public wage as the only source of income. The profile of these workers suggest that while educated, they tend to be older workers in the same position in the public sector for a long time, and may not have the right skills set to be competitive in a labor market already stagnant with high unemployment. Some workers, particularly from railways companies are located in small towns or in regions of the country (for example, Southern and Eastern Serbia) where the prospects of finding new employment can be weak. Previous qualitative research of

[51] Cancho, Cesar and Trang Van Nguyen (2016) Poverty and Social Impact Analysis of Workforce Rightsizing in the Public Sector in Serbia: Discussion Draft. Unpublished mimeo.
[52] Ruggeri, Caterina (2014) Addressing the Poverty, Gender and Social Impacts of Privatizations in Serbia: Discussion Draft. Unpublished mimeo.

workers laid off from PA companies suggests that their best chances of reemployment would be in informal casual jobs.[53]

4. **The rightsizing impacts are expected to have gender dimensions.** Workers are mostly female in Public Administration, especially in health (75 percent) and education (71 percent) where expected staff reductions are larger. In EPS and Railways, roughly 80 percent of the labor force are men.

Table 5.1 Welfare Characteristics Across Groups of Workers

	Electricity /1	Transport /2	Total non-SOE Public	Private Formal	Private Informal
Welfare characteristics					
Relative Poverty (<60% median income)					
Non-poor	98.9	89.5	96.7	88.3	52.7
Poor	1.1	10.5	3.3	11.7	47.4
Income Quintiles					
Lowest	1.1	4.6	1.9	8.6	39.1
2	5.8	17.2	8.6	16.1	26.8
3	10.1	25.3	14.6	22.3	17.6
4	24.6	22.4	26.4	26.1	10.6
Richest	58.4	30.5	48.5	26.8	5.9
Vulnerability Indicators					
Only adult employed in household	33.3	40.2	34.8	34.3	30.8
Only source of income	8.5	22.3	13.2	11.4	8.6
Bad health	5.4	7.7	4.9	3.8	13.3
Chronic illness	15.1	18.3	14.8	11.2	21.3
No one to talk problems	4.9	4.3	3.1	2.9	3.2
No friends or relatives to help	16.3	12.9	9.3	9.9	11.8
Pays rent	13.2	10.8	14.8	12.4	3.1

Source: World Bank staff elaboration based on 2013 Survey on Income and Living Conditions.
Note: 1/ Electricity refers to public workers in the electricity, gas, steam and air-conditioning supply industry. 2/ Transport refers to public workers in the railways, road and pipeline transportation industry. Analyses available in Cancho and Nguyen (2016) show that Electricity and Transport categories capture to a large extent the characteristics of EPS and Railways Companies workers and hence can act as proxies for workers from those companies for the analysis. Non-SOE Public sector workers include public workers on the Public Administration, Health, Education, and Other Services (for example, financial, professional). Private formal and informal refers to registered and unregistered companies, as defined in the SILC.

Poverty and Social Impacts of Higher Electricity Costs

5. **An increase in household (guaranteed supply) electricity tariffs by 3.8 percent is expected to have a small adverse impact on energy affordability in the short run, particularly among the poor and single elderly.** Based on the EU Survey on Income and Living Conditions (SILC), almost one in five households in Serbia report that they cannot keep their home adequately warm; a share higher than

[53] Ruggeri, Caterina (2014) Addressing the Poverty, Gender and Social Impacts of Privatizations in Serbia: Discussion Draft. Unpublished mimeo.

in most of the new EU member countries.[54] The rate is particularly high, 65.6 percent, among households in the bottom income quintile. Arrears and late payments of bills are common: 45.8 percent of lowest income households in Serbia have incurred at least one late payment in utility services, compared to only 14.7 percent in the top quintile.

6. **The poor and the elderly living alone spend more of their budget on electricity than other household categories, making them** more **vulnerable to increases in electricity tariffs.** The poorest quintile spends 8.9 percent of their total expenditures on electricity while the top quintile spends less than 5 percent. The elderly living alone, while often not among the poorest, tend to pay large heating and lighting expenses for their apartments out of their pension income. Single elderly households spend 14.9 percent of expenditure on energy and 8.6 percent on electricity, significantly higher than the average. Similarly, households with minimum pensions and recipients of financial social aid (FSA) have relatively high budget shares of electricity expenditures, at 7.6 percent and 6.7 percent respectively.

7. **The 2016 tariff increase is expected to increase electricity poverty but would have a very limited impact on poverty.** The effect of the electricity tariff increase of 3.8 percent in 2016 is simulated to have marginally increased the burden of electricity spending in total household budget: by 0.17 percentage points for the bottom quintile and by 0.13 percentage points for the average. The higher tariff is estimated to have a negligible impact on the overall poverty rate (0.2 percentage point increase) when measuring poverty using an anchored relative poverty line (60 percent of the median per adult equivalent household consumption).[55] The share of electricity poor households, that is, those with electricity accounting for more than 10 percent of spending, is expected to increase the most for the poorest quintile and elderly living alone (both by 1.5 percentage points). The cumulative electricity tariff increase of 16.256 percent (initial 12 percent in August 2015 plus the prior action 3.8 percent increase in 2016) is simulated to have a larger effect, increasing the electricity budget share by 0.68 percentage points for the bottom quintile and by 0.52 percentage points for the average due to the combined tariff rise. The share of electricity poor households among the poorest quintile and elderly living alone is calculated to have increased by 6.3 and 7.0 percentage points, respectively, and poverty to increase from 15.0 percent to 16.0 percent.

8. **As part of Prior Action 4, the DPL also supports additional funding of the existing energy bill discount program to protect vulnerable households against high energy expenditures.** Following the implementation of the first tariff increase in August 2015, an inter-ministerial working group was established to develop a new Decree on Energy Vulnerable Customers. The working group, chaired by the Ministry of Mining and Energy, drafted the amended decree with the objective of expanding coverage of vulnerable households. The amended decree was approved on December 31, 2015 and additional budget allocation was provided. The decree eased some of eligibility criteria (for example, asset test under the local government window) with the most notable design change the setting of the energy consumption thresholds for 2016 at a significantly higher level. Another obstacle to take up was also removed - the existence of energy bill arrears will no longer affect the eligibility for the current bill. However, as an unintended consequence of the amended decree, the procedure for obtaining the status of vulnerable customer has become more complicated for the FSA and child

[54] World Bank (2016) How Vulnerable are Serbian Households to High Energy Expenditures? Energy Affordability, Tariff Increase, and Protection of Vulnerable Populations in Serbia. Unpublished mimeo.

[55] Relative poverty rate is estimated at 15 percent, using the 2013 Household Budget Survey. For more details on the simulation see Nguyen, Trang Van and Monica Robayo-Abril (2016) Energy Affordability and Impacts of Tariff Reform on Household Welfare in Serbia. Unpublished mimeo.

allowance (CA) beneficiaries in 2016. As a consequence of a legal challenge to the earlier Decree, the amended decree turned local self-governments into the only implementing agency for the benefit. This has led to a duplication of the verification process for FSA and CA recipients, representing a new and significant administrative hurdle that has led to relatively low numbers of beneficiaries in early 2016, though these have been increasing to date. The second DPL aims to support the government in further strengthening the protection of vulnerable households against rising electricity tariffs.

9. **Electricity prices increases will have gender dimensions.** 31.9 percent of households are headed by a female. In addition, female-headed households spent a much larger share of expenditure on energy (13.2 percent) than male-headed households (11.3 percent). The share of electricity is also higher among female-headed HH (7.2 percent vs. 6.6 percent). Finally, the incidence of electricity poverty in this group is higher than among male-headed households (21.1 percent vs. 16 percent), making them more vulnerable to electricity price increases. Strengthening the energy bill discount program is important to cushion the impacts, including for female-headed households.