MINISTRY OF FINANCE

Dr. Jim Yong Kim

President

The World Bank

1818 H Street, N.W.

Washington, D.C., 20433

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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