

**PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE**

October 31, 2016
Report No.: 110223

Operation Name	First Serbia Public Expenditure and Public Utilities DPL
Region	EUROPE AND CENTRAL ASIA
Country	Serbia
Sector	General energy sector (34%); General public administration sector (33%); General transportation sector (33%)
Operation ID	P155694
Lending Instrument	Development Policy Lending
Borrower(s)	GOVERNMENT OF THE REPUBLIC OF SERBIA
Implementing Agency	MINISTRY OF FINANCE
Date PID Prepared	October 31, 2016
Estimated Date of Appraisal	November 7, 2016
Estimated Date of Board Approval	January 5, 2017
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the appraisal and negotiation of the operation.

I. Country and Sector Background

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. 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. Between 2009 and 2015, public debt doubled to reach over 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. 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.

The global financial crisis resulted in a deterioration of living conditions in Serbia, although poverty has since slowly receded. Poverty peaked at 15.1 percent in 2010 but then declined to 14.5 percent in 2013, the latest year for which comparable data using the \$5/day poverty line (2005 PPP) 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. Since the crisis, consumption among the bottom 40 percent declined more than the average, due to losses in employment and labor income. Labor market outcomes have improved slightly in recent years, though unemployment remains high

The combination of economic pressures, an improvement in relations with Serbia's neighbors and domestic reform momentum, provided an important opportunity to accelerate reforms. Following elections in March 2014, a government with a strong majority was formed. 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.

II. Operation Objectives

The proposed Public Expenditure and Public Utilities Development Policy Loan (DPL) – the first in a programmatic series of two operations – 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 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.

Improved public expenditure management through strengthened PFM is supported by actions aimed at improving control and recording of commitments and arrears. A prior action supports the monitoring framework for implementation of the amended Law on Deadlines for Payments in Commercial Transactions to capture transactions between public entities. A related indicative trigger for the 2nd DPL focuses on putting in place a system of ex ante commitment control and recording of commitments and expenditure arrears.

Public administration reforms under the DPL aim to improve management of public employment and the wage bill. This includes the introduction of a system of hard employment ceilings by institution and as well as reforms to the public sector pay and grading system, with a prior action on the adoption of the Law on Public Sector Employees Salary System to rationalize the public sector pay structure. Further implementation of these reforms through mapping of employees to new grades and their payment on the basis of these grades is a proposed indicative trigger in the second DPL.

Under the Pillar B the DPL series will support implementation of measures critical to improving the financial sustainability and efficiency of *Elektroprivreda Srbije* (EPS, Serbia's national electric power utility) and *Srbijagas*. For EPS, the DPL supports electricity tariff adjustments. To accompany tariff adjustments, the DPL series also supports the adoption of a decree, and increased funding in the 2016 Budget, to strengthen the targeted program to protect vulnerable households against energy tariff increases. Rightsizing of EPS's labor force is an important measure to reduce costs and improve efficiency, thereby improving the company's financial position. The DPL series supports the adoption and implementation of a medium-term "Labor Optimization" for EPS.

To sustain improvements in *Srbijagas*'s financial position, the government has adopted a high-level reform program laid out in the company's financial consolidation plan (FCP). Following adoption of the FCP (a prior action for the first DPL), the proposed indicative triggers in the second DPL support implementation of key measures to improve *Srbijagas*'s financial sustainability, aiming to enforce payment discipline, improve the economic and financial assessment of the company's investment program and oversight of internal controls.

Pillar C focuses on improving the efficiency of transport public enterprise and state-owned companies to reduce their fiscal burden. This includes a prior action on setting the financing policies and performance criteria for the operation of the new railways operating companies. The 2nd DPL is proposed to support focus on additional measures to put the new companies on a sound financial footing and improve their efficiency, such as resolution of the allocation of stock of debt and improving financial transparency standards and systems. Implementation of labor rightsizing is also a key component of delivering improved efficiency for the railways companies which is supported by the DPL. The second DPL is also proposed to support improved efficiency in roads through adoption of a medium-term service-level agreement between the Government and Roads of Serbia with clear goals and medium-term performance targets linked to secure financing. This can support improved long-term planning, and lead to a better quality of investment and asset preservation, and improved accountability.

III. Rationale for Bank Involvement

The proposed DPL will support implementation of challenging reforms that are critical to the government’s fiscal consolidation and structural reform agenda. The measures supported are an integral part of the government’s ambitious program of critical policy and institutional reforms and support implementation of strategic sector objectives in the context of Serbia’s EU accession process. The successful implementation of reforms in public administration, energy, and transport sectors is expected to improve economic efficiency and create foundations for faster growth and private-sector led job creation over the medium term.

The proposed DPL series is central to the World Bank CPF FY16-FY20 Focus Area 1: “Economic governance and the role of the state” and has been prepared under the close coordination and cooperation with relevant stakeholders including development partners. The 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. The design of the operation is fully coordinated with the IMF Stand-By Arrangement, with complementary actions to support reform implementation. It also builds on, and is coordinated, with related other WB activities, including analytical and technical assistance, the DPL series supporting commercial SOE reform and the Program-for-Results operation on Modernization and Optimization of Public Administration.

IV. Tentative financing

Source:	(\$m.)
Borrower/Recipient	0
International Bank for Reconstruction and Development	200
Total	200

V. Institutional and Implementation Arrangements

The DPL series is part of a broad and deep World Bank Group engagement with the Government on public expenditure management, energy and transport, public enterprise and commercial SOEs and job-related reforms, including related technical assistance and investment projects. 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 Public Administration and Local Self Governance, 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 government strategies and action plans with their own results framework and monitoring mechanisms, for example, the broad ERP and the Public Administration and PFM Reform Action Plans. Progress on rightsizing is particularly closely monitored by the government.

VI. Risks and Risk Mitigation

The overall risk rating of this operation is substantial. Political and governance risks, and macro, risks are substantial. Implementation of the DPL-supported reforms, particularly on rightsizing and financial consolidation measures in energy and rail, will require strong political support. These risks are being mitigated by the government's demonstrated commitment to implementation of the reform agenda, and the anchors of EU accession prospects, and IFI support. Macroeconomic risks may arise from external macro developments or slippage on fiscal consolidation efforts. These risks are mitigated by the IMF program and other IFI support, including this DPL series. Implementation risks are also substantial given the broad-ranging reform agenda and the institutional capacity of respective ministries and public utilities. To mitigate these risks, the government has mobilized extensive technical assistance and support from the World Bank, the EU, and other partners.

Stakeholder and social and environmental risks are rated as substantial, particularly relating to labor rightsizing. Tariff reform and reform of energy and transport companies has faced strong resistance in the past due to strong stakeholder groups (e.g. unions) and a lack of confidence that the increased revenues (through higher tariffs) and cost reductions (including labor rightsizing) would benefit the broader population. To mitigate these risks, the operation supports measures aimed at improving transparency and accountability mechanisms. The DPL series also supports a strengthened program to protect vulnerable households from electricity price increases. The various labor rightsizing programs have been discussed with the respective unions, with further consultation during implementation needed. Notwithstanding the fact that significant adverse environmental impacts are not expected, social and environmental risks overall are rated as high for the above reasons.

VII. Poverty and Social Impacts (PSI) and Environmental Aspects

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. As mentioned above, over the medium- to longer-term, the reforms supported by the DPL are expected to improve the quality of public service delivery and support improve economic performance. However, in the near-term negative distributional and social impacts are likely to be felt for household immediately affected and vulnerable to workforce rightsizing and higher electricity costs. The overall aggregate poverty impact is though expected to be limited given that mitigating measures are in place, including compensation packages for retrenched workers, existing programs of employment support and labor regulations; the affected workers tend to be in the middle and upper quintiles of the income distribution; and the government has increased the budget to expand the targeted

assistance program to mitigate tariff increases and the electricity price increase in 2016 is relatively low.

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. In order to minimize adverse effects on affected workforce, the design of the Labor Optimization plans for EPS and the railway companies was informed by the domestic policy and legal framework and international good practice. Adequate consultation with workers, monitoring and evaluation, will support implementation of the retrenchment processes. In addition, the National Employment Service has already put in place specific measures to support retrenched workers and its capacity and effectiveness is being strengthened, including through other World Bank operations, such as the previous SOE Reform DPL series and the Competitiveness and Jobs project.

Some of the impacts discussed are expected to vary by gender. With respect to rightsizing measures, workers tend to be mostly female in Public Administration, especially in health and education, sectors where the expected staff reductions are among the largest. In contrast, in EPS and Railways Companies, roughly 80 percent of the labor force are men. Strengthening the energy bill discount program as supported by the DPL is important to cushion the impacts, including for female-headed households for whom the incidence of electricity poverty is higher.

The reform policies supported by the DPL series are not likely to have significant effects on the environment, forests and natural resources. By supporting electricity tariff rises, which help correct distorted price signals, the operation is likely to have some environmental benefits through improved energy efficiency. Improved operational efficiency in the transport sector would also likely result in fuel savings, contributing to improved environmental sustainability. The legal and regulatory framework for addressing environmental damage and liabilities is deemed adequate, although implementation is frequently hampered by broader institutional and financial capacity constraints.

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