Council of the
European Union

Brussels, 25 April 2017
(OR. en)

8439/17

ECOFIN 296
UEM 96
ELARG 30

COVER NOTE

From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	21 April 2017
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
No. Cion doc.:	SWD(2017) 142 final
Subject:	COMMISSION STAFF WORKING DOCUMENT ECONOMIC REFORM PROGRAMME OF SERBIA (2017-2019) COMMISSION ASSESSMENT

Delegations will find attached document SWD(2017) 142 final.

Encl.: SWD(2017) 142 final

Brussels, 21.4.2017
SWD(2017) 142 final

COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

SERBIA
(2017-2019)

COMMISSION ASSESSMENT

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1. EXECUTIVE SUMMARY

Economic growth is forecast to firm up slightly. In 2016, the economy expanded by 2.8%, faster than expected, and surpassed its pre-crisis peak as consumption and export beat initial expectations. The programme forecasts a slight acceleration of economic growth, increasingly underpinned by private consumption, while investment and export are projected to remain robust. Inflation is expected to increase moderately but short-term price pressures are contained. The current account deficit is forecast to stabilise at around 4 % of GDP and to be fully covered by net foreign direct investment (FDI). Non-performing loans (NPLs) declined, helped by the implementation of the NPL resolution strategy and reinvigorated lending.

The macroeconomic scenario is plausible but requires strong reform commitment and steadfast implementation. The economy's structure has changed markedly over the last several years away from consumption towards exports. Sustaining this growth model, however, would require continued investments in expanding the tradable sector, improving the business environment, and upgrading infrastructure. The economy is vulnerable to financial and commodity market shocks and is exposed to developments in the EU, which is the main export market and source of most of the foreign investment inflows.

The main challenges in this respect include the following:

- **Avoiding policy complacency and 'reform fatigue' is a key challenge as successful macroeconomic stabilisation has reduced the pressure for reforms.** The legacy of the unreformed public sector has continued to weigh on the budget and the economy. The slow and uneven progress in restructuring state-owned enterprises (SOEs) and delays in the tax administration reform remain a concern. Challenges remain to further improving budgetary planning and execution. Fiscal rules are weak and require substantial revision to make them more binding and relevant for policy making. Progress with addressing the very high level of NPLs was uneven across banks. Further efforts are required to strengthen the financial performance and governance of state-owned financial institutions, and to advance their privatisation.
- **The envisaged medium term consolidation path could be more ambitious without straining economic growth.** Following an impressive reduction of fiscal imbalances in the last 2 years, the pace of consolidation is forecast to slow significantly. The programme targets reaching a budget deficit of 1 % of GDP by 2019 and identifies additional fiscal space in 2018 and 2019 to be used for accommodating new policy initiatives. However, in view of the better than expected performance and outlook, the still very high level of public debt, revenue volatility, and elevated fiscal risks, it would be prudent to use at least part of this space to further reduce budget deficits.
- **The energy sector continues to be a risk for public finances and management of public investment remained weak.** Public utility companies have not been effectively restructured yet, which hampers the functioning of the energy market. The Economic Reform Programme (ERP) remains vague on reorganising the inefficient system for prioritising and managing public capital expenditure. Better use should be made of the single project pipeline to cover all large public investment projects.

- **The business environment has only improved in limited areas; the burden of red tape and the informal economy is very high.** There is no progress with regulation of parafiscal charges and, despite low inflation, many companies, notably small and medium sized enterprises (SMEs), remain without access to affordable finance. The informal economy is large. The ERP recognises this as a problem, but the response is limited to a reform of the tax administration and an e-inspection service.
- **The labour market continues to be characterised by low activity rates, low level of skills and skills mismatch and a framework that discourages part-time work and formal work in the low earning segments.** Structural deficits across the education system cause low levels of basic skills among a considerable proportion of young people. Moreover, the provision of medium- and higher-level qualifications that do not meet labour market needs is hampering the swift transition of young people to the labour market. At the same time, talented young people are leaving the country. Reforms have started in the skills governance system and further reforms are planned that will introduce entrepreneurial education and dual learning in vocational education and training. It would also be helpful to envisage more ambitious labour market reforms and labour force activation measures. These are also key for improving prosperity levels among the population, which is still strongly affected by poverty.

The policy guidance jointly adopted at the Economic and Financial Dialogue of 25 May 2016 has been partially implemented. Progress was strong in reducing fiscal imbalances, and this provided the necessary space for continuing monetary policy accommodation. Important results were also achieved on reducing NPLs. The progress in restructuring state-owned enterprises was uneven and major challenges to finding a sustainable resolution for systemically important companies remain. The public administration reform advanced as well, although it continues to face implementation delays. Revenue collection improved significantly but needs to be sustained by implementing the tax administration transformation programme. The management of public projects has not improved, but the commitment to the gas interconnector with Bulgaria was reinvigorated. Regulatory dialogue with businesses remains sporadic and little has been done to improve the predictability of the business environment for investors concerning parafiscal charges or new regulation. Although the budget allocation remained stable, steps have been taken to increase the coverage of active labour market policies and strengthen the capacities of local employment offices.

The ERP partially matches the reform priorities identified by the Commission. The macroeconomic and fiscal frameworks are sufficiently comprehensive and coherent, providing a good basis for policy discussions. Stepping-up reform implementation remains crucial in order to lock-in recent gains in macroeconomic and fiscal stability, reduce structural rigidities, further improve the economic outlook, and strengthen the financial system. The structural reform part of the ERP remains largely unchanged from last year. This is appropriate from the perspective of challenges to competitiveness which remain broadly the same. There has been progress across reform areas and in many sectors there is a better acknowledgement of what needs to be implemented and how urgent these reforms are. The ERP fails, however, to recognise these developments and to adjust the reform measures accordingly. Overall, there is an imbalance in the ERP toward infrastructure investments. This comes at the expense of proper structural and market reforms with a potentially larger impact on competitiveness. These mainly relate

to the informal economy, parafiscal regulation and transparency of state involvement, and to raising employment levels.

2. ECONOMIC OUTLOOK AND RISKS

Economic growth is forecast to firm up slightly. In 2016, the economy expanded faster than expected and surpassed its pre-crisis peak as consumption and export beat initial expectations. Increased confidence as a result of implemented reforms, stronger external demand and tail winds from low oil prices supported the nascent recovery. Boosted by rising employment and private sector wages, household consumption recorded a marginal growth for the first time after years of decline. The programme envisages a slight acceleration of economic growth to 3.0% in 2017 and 3.5% for the two last years. Growth is forecast to be increasingly underpinned by private consumption, while investment and export are projected to remain robust. On the supply side, industrial production and services are expected to be the main drivers of economic activity.

The macroeconomic assumptions are plausible but require strong reform commitment and steadfast implementation. The baseline scenario is broadly in line with the latest Commission forecast. It recognises the presence of a new growth momentum, based on sounder fundamentals. The economy's structure has changed markedly over the last several years away from consumption towards exports. Sustaining this growth model, however, would require continued investment in expanding the tradable sector, improving the business environment and upgrading infrastructure. Stepping up reform implementation and creating additional fiscal space for productive capital expenditure, as envisaged by the programme, would therefore support investment and export-led growth in the years to come. Private consumption growth is poised to accelerate, buoyed by further gains in employment and wages and by a less restrictive fiscal stance. Continuing a sustainable rebalancing of the economy would, however, require that private consumption growth does not become excessive.

Table 1:

Macroeconomic developments and forecasts

	2015		2016		2017		2018		2019	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	0.8	**0.8**	2.8	**2.7**	3.0	**3.0**	3.3	**3.5**	n.a.	**3.5**
Contributions:										
- Final domestic demand	1.0	**1.1**	2.4	**2.4**	3.1	**2.5**	3.6	**3.2**	n.a.	**3.5**
- Change in inventories	0.4	**0.5**	-0.4	**-0.4**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	-0.6	**-0.8**	0.8	**0.6**	0.0	**0.5**	-0.3	**0.3**	n.a.	**0.0**
Employment (% change)	0.6	**1.0**	4.7	**1.1**	1.1	**1.2**	1.5	**1.4**	n.a.	**1.4**
Unemployment rate (%)	17.7	**18.2**	16.1	**17.0**	14.3	**16.0**	12.6	**14.7**	n.a.	**13.2**
GDP deflator (% change)	2.7	**2.7**	1.0	**1.3**	1.7	**1.6**	2.9	**2.8**	n.a.	**3.0**
CPI inflation, annual average (%)	1.4		1.1	**1.1**	2.4	**2.4**	3.3	**3.0**	n.a.	**3.0**
Current account balance (% of GDP)	-4.7	**-4.7**	-4.0	**-4.1**	-4.2	**-4.1**	-4.2	**-3.9**	n.a.	**-3.9**
Budget deficit (% of GDP)	-3.7	**-3.7**	-1.3	**-2.1**	-1.2	**-1.7**	-1.0	**-1.3**	n.a.	**-1.0**
Government debt (% of GDP)	74.6	**76.0**	73.7	**74.6**	72.3	**73.9**	69.8	**70.7**	n.a.	**67.0**

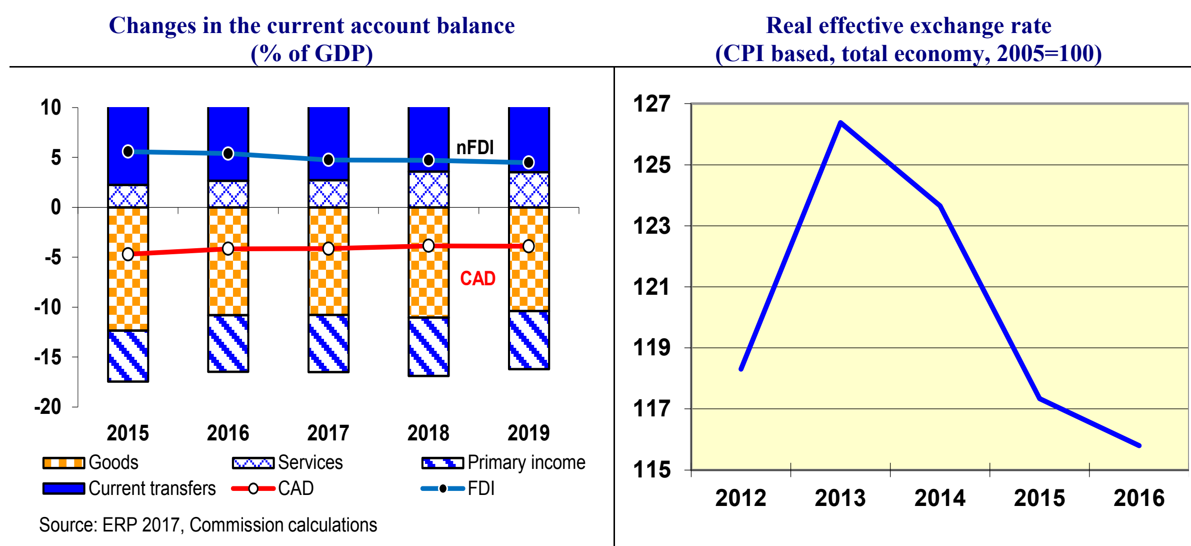
Sources: Economic Reform Programme (ERP) 2017; Commission Winter 2017 Forecast

Risks are not negligible. They are clearly identified in the programme, which also presents an alternative, pessimistic scenario, envisaging lower cumulative growth of just 5.2 % in the period 2017-2019. Due to the recent reduction of domestic and external imbalances, the economy is much better placed to face some of the risks. However, it is

exposed to developments in the EU, which is the main export market and source of most of the foreign investment inflows. The economy is also vulnerable to financial and commodity market shocks as it remains highly dependent on foreign capital and energy imports. On the domestic side, avoiding policy complacency and 'reform fatigue' is a key challenge as successful macroeconomic stabilisation has reduced the pressure for reforms.

Inflation is expected to increase moderately but short-term price pressures are contained. Over the last few years, inflation was stable and at historically low levels, undershooting expectations and the central bank target tolerance band. Strong fiscal consolidation and shrinking external imbalances provided room for further monetary policy relaxation and underpinned a relatively stable exchange rate. Low inflation and inflationary expectations allowed the central bank to reduce its inflation target by 1 pp. to 3 % ± 1.5 pps. as of 2017. The lower target still allows for gradual price convergence with advanced economies through the Balassa-Samuelson effect, and is also expected to support confidence in the domestic currency and its use in the economy. Over the short term, the good agricultural season and limited adjustments of administered prices are expected to contain price pressures. However, as the effects of major disinflationary factors, such as low international prices and subdued domestic demand, dissipate or are being reversed, inflation is forecast to rise and approach the new central bank target.

Graph 1: **External competitiveness and the current account**



The current account deficit is expected to stabilise at around 4 % of GDP. The deficit fell more strongly than expected in 2016, mostly due to better export performance. Robust inflows of FDI in tradable sectors — particular manufacturing — have boosted export capacity in the last few years. The reduction of the public savings-investment gap contributed decisively to the continuing fall in external imbalances. Thus, with the envisaged slowdown of fiscal adjustment, a major driving force for supressing these imbalances would weaken significantly. As private investment is forecast to move broadly in line with private savings, the programme expects the current account to stabilise at just below 4 % of GDP. There are certain risks to this profile, however. On the downside they come from potentially higher financing costs and negative terms of trade developments. On the upside, the risk is from continued stronger than expected export performance in manufacturing.

Attracting FDI remains crucial for making further gains in competitiveness and underpinning growth. Increases in price competitiveness have been limited recently and are expected to remain so over the medium term. Further improvements in external competitiveness are envisaged to come mainly as a result of productivity-enhancing reforms and investment. Net FDI inflows have been on the rise and fully covered the current account deficit in the last 2 years. They were broad-based and a dominant part of them went into manufacturing and other tradable sectors which helped Serbia expand its global market share. The programme prudently assumes a broadly unchanged nominal level of net FDI inflows, sufficient to cover the current account deficits over 2017-2019. The current account deficit, although reduced, is expected to continue worsening the net international investment position, which is now clearly above 100 % GDP. On the liabilities side, however, the stock of FDI makes up more than half of all obligations, limiting vulnerabilities to a sudden worsening of external financing conditions. In addition, maintaining a comfortable level of foreign reserves and a continued steadfast implementation of the Stand-By Arrangement with the IMF represent important buffers against external risks.

Financial sector resilience improved but still faces major challenges. Macroeconomic stabilisation and acceleration of growth were instrumental in bringing down financing costs and reviving lending activity. Credit to households picked up strongly, while corporate loans, although on the rise as well, lagged behind. The deposit base expanded further, covering almost fully claims on non-government sectors. Despite some inroads in increasing the use of the dinar, the banking system remained heavily 'euroised' on both the assets and liabilities side. Increased reliance on domestic funding allowed banks to reduce their net foreign liabilities. The sector's exposure to the state continued rising and claims on the government reached nearly 18 % of total assets. Commercial banks remained liquid and well-capitalised and their profitability increased, although some still ran losses last year. The implementation of the NPL resolution strategy and reinvigorated lending helped bring down the NPL ratio by 4.5 percentage points to 17%. However, progress was uneven and state-owned banks in particular have not yet satisfactorily addressed the problem. Further efforts are also required to strengthen the financial performance and governance of state-owned financial institutions and to advance their privatisation.

Table 2:

Financial sector indicators

	2012	2013	2014	2015	2016
Total assets of the banking system, mEUR	34 980	34 378	34 618	35 655	36 992
Credit growth	9.5	-4.4	3.1	2.9	2.5
Deposit growth	10.4	3.3	7.6	6.5	11.4
Loan to deposit ratio	1.3	1.2	1.1	1.1	1.0
Financial soundness indicators					
— non-performing loans	18.6	21.4	21.5	21.6	17.0
— total provisions to gross NPLs	120.7	113.8	114.5	114.2	118.9
— regulatory capital to risk weighted assets	19.9	20.9	20.0	20.9	21.8
— liquid to total assets	34.5	38.5	35.6	34.3	36.9
— return on equity	2.1	-0.4	0.6	1.6	3.4
— forex loans to total loans*	73.1	70.9	70.0	71.9	69.3

Sources: ERP 2017, National Central Bank, DataInsight
**Includes both denominated and indexed positions.*

3. PUBLIC FINANCE

Fiscal consolidation remained very strong. Following a marked reduction in 2015, the budget deficit was cut significantly again to 1.4 % of GDP last year.[1] The outcome far outperformed initial and revised targets and was mainly due to better revenue performance. Favourable macroeconomic developments, improved tax collection and unplanned one-off receipts all contributed to this result. Expenditure, on the other hand, remained largely under control and saw a further fall in current spending. Despite limited indexations in 2016, spending on pensions and wages declined as a percentage of GDP, although they are still above the respective ceilings prescribed by the fiscal rules. Importantly, the lower budget deficit broke the trend of rising interest costs and government debt ratio and both fell for the first time since 2008. The strong budget performance also created space for increasing capital expenditure, in particular on big infrastructure projects, accommodating one-off payments to pensioners and taking over some debt owed by state-owned enterprises.

The legacy of the unreformed public sector continued to weigh on the budget and the economy. The slow and uneven progress in restructuring SOEs and delays in the public administration reform remain key concerns and come at a significant, often unplanned, cost to the budget. They also force the preservation of inefficient and often burdensome and ad hoc solutions, such as the extension of an employment attrition rule for the public sector for another year, to 2017. The level of government spending is high and its structure is still not sufficiently supportive of growth. State aid to public companies is significant and is often granted in a non-transparent manner. Key budget systems, processes and institutions need to be strengthened to improve budget transparency, boost efficiency and support sustainable fiscal consolidation.

Table 3:

Composition of the budgetary adjustment (% of GDP)

	2015	2016	2017	2018	2019	Change: 2016-19
Revenues	41.9	43.3	42.4	41.6	41.1	-2.2
- Taxes and social security contributions	35.9	36.8	36.8	36.3	36.1	-0.8
- Other (residual)	6.0	6.5	5.6	5.3	5.0	-1.4
Expenditure	45.6	45.4	44.1	42.9	42.1	-3.3
- Primary expenditure	42.4	42.1	41.0	40.0	39.5	-2.7
of which:						
Gross fixed capital formation	2.8	3.1	3.3	3.5	3.6	0.5
Consumption	16.7	16.9	16.7	16.2	16.0	-0.9
Transfers & subsidies	20.9	19.9	18.9	18.1	17.6	-2.3
Other (residual)	1.9	2.2	2.1	2.1	2.3	0.1
- Interest payments	3.2	3.3	3.1	3.0	2.7	-0.6
Budget balance	-3.7	-2.1	-1.7	-1.3	-1.0	1.1
- Cyclically adjusted	-3.2	-1.9	-1.6	-1.4	-1.1	0.8
Primary balance	-0.5	1.2	1.4	1.6	1.7	0.5
Gross debt level	76.0	74.6	73.9	70.7	67.0	-7.6

Sources: ERP 2017, Commission calculations.

[1] The text comments on the actual execution data for 2016, which differ from those in the ERP.

The envisaged medium-term consolidation path could be more ambitious without straining economic growth. Following an impressive reduction of fiscal imbalances in the last two years — the structural deficit was cut by more than 4 % of GDP — the pace of consolidation is forecast to slow down significantly. The programme targets reaching a budget deficit of 1 % of GDP by 2019, to be achieved primarily by a further reduction of expenditure. Importantly, and for the first time, the medium-term framework has also identified additional fiscal space of 0.3 % of GDP in 2018 and 0.8 % of GDP in 2019. This gives the authorities leeway for accommodating new policy initiatives. However, in view of the better than expected 2016 outcome, the positive macroeconomic outlook, the still very high level of public debt, revenue volatility, and high fiscal risks, it would be prudent to use at least part of this space to further reduce budget deficits.

The 2017 budget is conservative and builds upon recent successes. It sets a deficit target of 1.7 % of GDP (defined before the favourable deficit outcome for 2016 became known) which includes some reserves and is also subject to upside risks on the revenue side. There are no major changes in tax policy and tax rates in 2017 and over the span of the programme. The revenue ratio is expected to fall by 0.9 % of GDP in 2017, mostly due to a decline in non-tax revenue after a surge in one-offs the previous year. Tax revenue is kept broadly unchanged as a ratio to GDP, reflecting the forecast dynamics of respective tax bases, without taking into account any possible gains due to improved collection and reduction of the informal economy. The positive momentum built up on the revenue side in 2016 has allowed for a targeted increase of salaries by 3-6 % in some segments of the public sector and a 1.5 % indexation of pensions. Nevertheless, the expenditure on wages and pensions, representing nearly half of total spending, is still set to decline further as a percentage of GDP.

The successful implementation of structural reforms would further support a sustainable fiscal consolidation. Major savings are expected in subsidies and payments on activated guarantees, which are dependent on further advancing the restructuring of state-owned enterprises. Continuing the reform of the public administration, although not expected to bring significant direct savings, is also of key importance for improving public sector efficiency and providing better-quality service in important sectors such as health and education. More determined implementation of the tax administration transformation programme is needed to institutionalise recent gains in revenue collection. In addition to their impact on the budget, these major reforms have an important effect in signalling the authorities' commitment to the process of modernising the economy and improving the business environment, thus, affecting the overall country risk premium.

Fiscal risks are clearly outlined in the programme. They are topped by concerns about the impact of public enterprises on government finance. These range from state-guaranteed loans, subsidies and transferring of liabilities to the budget, to foregone tax revenue. In this context, the recent improvement of financial performance of state-owned enterprises is encouraging, although some of them still remain loss making and undercapitalised. On the basis of a pessimistic macroeconomic scenario, the programme presents an alternative fiscal path with a less pronounced reduction of the government debt and deficit. It also flags the importance of strengthening banking system supervision and stability to reduce the budget's exposure to risks from the financial sector. Idiosyncratic risks from court rulings and national disasters are mentioned as well. Possible future restitution-related obligations of up to EUR 2 billion or some 5 % of GDP to be issued in 2018 have not been incorporated into the analysis, however.

Government debt is on a downward path for the first time since 2008. As a result of fiscal consolidation efforts and a sizeable budgetary over-performance, government debt fell in 2016 after years of constant increase. The reversal of debt dynamics came a year earlier than expected thanks to larger-than-forecast primary balance and economic growth, and a drawdown of budget deposits. A marginal increase of primary surpluses and a steady expansion of the economy are forecast to drive a continued reduction of government debt to 67 % of GDP in 2019. Lower debt, for its part, is a main factor in the projected further fall in interest expenditure to below 3 % of GDP already next year.

There are significant downside risks to the debt trajectory which call for judicious use of any over-performance in the budget. Under the baseline, government debt and debt servicing would still remain very high. Refinancing risks are prominent, with gross financing needs averaging above 16 % of GDP over the next 3 years. In view of the high share of foreign currency in its structure, government debt is highly vulnerable to a depreciation of the dinar. Despite recent progress, the poor overall financial situation of some large state-owned enterprises remains a source of sizeable implicit liabilities for the budget. In addition, restitution-related obligations could also pose a challenge to the envisaged reduction of government debt. Finding a sustainable solution to controlling expenditure on wages and pensions is needed as well. Reform 'fatigue' and fiscal slippages are also not excluded, especially after the programme with the IMF expires in early 2018.

Box: Debt dynamics

Table 4:

Composition of changes in the debt ratio (% of GDP)

	2015	2016	2017	2018	2019
Gross debt ratio [1]	**76.0**	**74.6**	**73.9**	**70.7**	**67.0**
Change in the ratio	4.1	-1.4	-0.7	-3.2	-3.7
Contributions [2]:					
1. Primary balance	**0.5**	**-1.2**	**-1.4**	**-1.6**	**-1.7**
2. 'Snow-ball' effect	**0.8**	**0.4**	**-0.1**	**-1.4**	**-1.6**
Of which:					
Interest expenditure	3.2	3.3	3.1	3.0	2.7
Growth effect	-0.5	-2.0	-2.1	-2.4	-2.3
Inflation effect	-1.9	-0.9	-1.1	-1.9	-2.0
3. Stock-flow adjustment	**2.8**	**-0.6**	**0.9**	**-0.2**	**-0.4**

[1] End of period. In accordance with the Budget System Law, includes all government-guaranteed debt and non-guaranteed local government debt. Differs from government debt according to the national methodology (Public Debt Law), which does not include non-guaranteed local government debt.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences between cash and accrual data.

Source: ERP 2017, MoF; Commission calculations.

The increase in the government debt to GDP ratio was reversed in 2016 due to a strong consolidation effort which brought the primary balance into surplus. Debt-reducing effects from real GDP growth and inflation intensified as well, almost fully offsetting the impact of high interest payments. The expected acceleration of economic growth and a moderate increase in inflation are seen as the main factors behind the forecast further decline of government debt, in particular in the last years of the programme. Stock-flow adjustments are expected to remain marginal, although restitution-related debt and potential privatisation (concession) receipts, not included in this scenario, could significantly impact debt dynamics.

Steps have been taken to improve budgetary processes and institutions but the fiscal framework needs to be strengthened further. Extra-budgetary loans have been integrated into the 2017 budget and work is under way to establish a single pipeline of investment projects. Monitoring of state-owned enterprises has been stepped up. The framework governing public-private partnerships and concessions has been upgraded to include fiscal risk statements and for projects larger than EUR 50 million the consent of the Ministry of Finance is required. Significant challenges remain, however, regarding further improving budgetary planning and execution. This includes improving coverage of the general government sector and integration of all units into the budget execution system. The fiscal responsibility framework — and the fiscal rules in particular — is weak and requires a substantial revision to make it more binding and relevant for policy-making, able to anchor consolidation efforts and control current expenditure. The Fiscal Council remained a prominent institution, supporting debates on fiscal policy. As the mandate of all members of the Council expires this spring, preserving continuity and institutional knowledge will likely be a challenge.

4. STRUCTURAL REFORMS

The structural reforms part of the programme is based on a sound analysis but reform prioritisation could be further improved. The ERP contains a realistic analysis of the key obstacles to competitiveness, growth, employment and social development. Many measures proposed are relevant and address the obstacles identified. However, the Commission assessment of the ERP for 2016-2018 has not been sufficiently taken into account in the revision of the measures included this year. In particular, there is an over-emphasis, both in terms of number of measures and the budget, on infrastructure investments at the expense of proper structural reforms with a potentially greater impact on competitiveness.

The measures included in the ERP are spread across nine different areas reflecting the main challenges for Serbia's competitiveness. Many of the measures in the programme deal with improved public support to businesses, such as access to finance, innovation, industrial prioritisation and quality infrastructure. The reforms of inspections and the tax administration are aimed at reducing the informal economy. The section on energy, transport and telecommunication markets, however, does not deal with the much-needed restructuring of the sectors, but rather lists a number of public investment projects. It also fails to include any connectivity reform measures, which would have a large impact on competitiveness at a lower cost. Contributions from the budget are envisaged in all measures, showing a commitment by the government to reform implementation. However, the budgeting of some measures only partially covers foreseeable costs, while many measures are co-financed by donors and international financial institutions (IFIs). The risks to implementation are identified to come mainly from sluggish administrative procedures, lack of cooperation between the institutions responsible, poor planning and budgetary shortcomings. This indicates the importance of efforts to modernise the administration in general. The programme would have benefitted from including information on planned activities to mitigate the identified risks.

The main structural bottlenecks to competitiveness include inefficient energy market in need of restructured and unbundled utilities, a relatively poor business environment and a large informal sector. There are delays in the implementation of some important reforms that have started a few years ago, at the depth of the economic crisis. This is particularly the case for measures which aim to improve the

competitiveness of the industrial and agriculture sectors and remove the burden of red tape. There is little reflection in the ERP as to how growth could be sustained in the medium term, how more formal jobs could be created to increase employment, how skilled young people could be kept in the country and more FDI attracted. In view of persistent delays of reform implementation, the end of the stand-by arrangement with the IMF in early 2018 represents a certain risk for the continuation of structural reforms. Last year's policy guidance related to structural reforms has been only partially implemented.

Public finance management

Key weaknesses in public finance management (PFM) affecting the competitiveness of the economy include the preparation and execution of the budget. Management of public funds could be improved to support fiscal consolidation and provide better public services. The ERP's diagnostic recognises these challenges; however, it does not make a link to the PFM reform programme and its action plan which have been prepared under the obligations of Chapter 32 in the accession negotiations. There are important delays in the implementation of the action plan; most notably, the mechanism for policy dialogue on implementation of the reform with relevant stakeholders is still to be operationalised. Public participation in the budget process is weak and budget oversight by the Parliament needs to be improved.

There has been progress in implementing the measure transforming the tax administration. The measure is rolled over from the previous ERP, but further assessment of the strengths and weaknesses of the tax administration was carried out by the IMF in 2016 under its Tax Administration Diagnosis Assessment Tool (TADAT). A modern system of risk analysis directed towards sectors and tax payers with higher probability of tax evasion is in the pipeline and needs to be effectively put in place. Keeping and recruiting qualified staff, particularly in the IT sector, is one of the Tax Administration's main challenges. Training and IT should be upgraded. Services to tax payers, in particular electronic filing, continued to be developed. They should be further improved through the planned establishment of a sector for services within the Tax Administration.

There was a limited progress in implementing the rolled-over measure to improve capital investment management. Capital expenditure execution remains hampered by weaknesses in budgeting, planning and contract oversight. Serbia has not yet put in place a unified and integrated platform for the prioritising, planning and managing of capital projects and investments. Such a structure should be based on the existing platform for capital investment, namely the National Investment Committee and the Single Project Pipeline.

Transport, energy and telecommunications markets

Low levels of investment in physical infrastructure continue to be an obstacle to economic development and regional integration. The comprehensive diagnostic in this area is well elaborated. Underdeveloped transport infrastructure coupled with a non-harmonised regulatory framework result in high transport costs and low levels of trade integration within the Western Balkan countries and with the EU. An underdeveloped electricity and gas transmission network and lack of interconnections make the energy market inefficient and limit its contribution to economic development. Access to broadband is well below the EU average.

The many sub-measures included in transport area focus on infrastructure investment only, neglecting the fact that infrastructure development needs to be

combined with structural market reforms. All eight projects in transport, energy and telecommunication markets are rolled over from last year's programme. The importance of modernising and expanding infrastructure is a core component of the EU-led connectivity agenda under the Berlin process. However, parallel progress in sector reforms including restructuring of public utilities and liberalisation is also needed and should be the focus of the ERP. While railway reforms have progressed steadily on the commitments made under the connectivity agenda, other reforms, such as the unbundling of Srbijagas, have yet to be fully tackled. Moreover, after the Paris Agreement on Climate and given the exceptionally high energy intensity in Serbia, higher priority should be given to energy efficiency measures. Price and tariff reforms would send the right signals for power usage and stimulate investment in energy efficiency.

The measure on developing the broadband network is still in its early phase. The adoption of a law on broadband communication infrastructure aligned with Directive 2014/61/EU has been delayed. It would create a regulatory framework facilitating and incentivising the roll-out of broadband networks. The mapping of broadband availability and penetration is still on-going. Private investments of €150 million have been announced, but need to be confirmed. In the coming years, a subsidy for the development of infrastructure in areas of low population density areas needs to be budgeted for. Similarly, although currently not envisaged, the regulation for providing e-government and e-services needs to be further developed.

Sector development

Agricultural sector development

The challenges facing the agriculture sector are land fragmentation, low productivity due to outdated technologies, small economic size and low utilisation of agricultural land per farm compared to the EU average. The diagnostic recognises these challenges but does not analyse the need to address further alignment of phytosanitary regulations with EU standards or border control procedures, which can contribute critically to improving the sector's competitiveness.

The measure to improve the competitiveness of agricultural holdings is seen only through the prism of legal and institutional framework adjustments in order to be able to use EU IPARD funds. However, national subsidies and the Instrument for Pre-Accession Assistance in Rural Development (IPARD), as identified in the measure, are just two of many vehicles to promote investments. Investments should also be encouraged by increasing the attractiveness of the sector. This could be done by creating a predictable legal framework, progressively liberalising the market for agricultural land and developing modern agricultural infrastructure (including irrigation systems, cadastre management, rural planning, access roads, storage facilities, etc.).

Industry sector development

The recent influx of FDI supported a recovery of industrial activity. However, as the programme points out, the sector continues to face difficulties; it is concentrated on raw materials and few manufacturing sub-branches, some companies depend on state aid, the share of high-tech companies is very low and there is a lack of cooperation with public researchers. Sustained investment in industry and manufacturing is needed to safeguard and upgrade the skills, improve productivity and so ensure the integration of a larger number of firms into global value chains.

The measure aimed at strengthening the competitiveness of the processing industry does not go far enough to constitute a substantial reform of the sector. The

programme proposes formulating action plans for priority branches of industry. However, this is not enough to achieve a significant impact on competitiveness. The current dialogue with the World Bank and the opening of Chapter 20 under the EU accession negotiations are starting points for a modern and inclusive industrial policy. The new strategy needs to include co-ordination mechanisms with policy areas such as the one for research and innovation and relevant performance benchmarks and provide guidelines to line ministries on how to design better support measures for industry. The Ministry of Economy cannot be the only ministry responsible. New instruments of industrial support need to be introduced to benefit smaller and local investors.

Steps have been taken to achieve better management and prioritisation of investment aid, which is a key part of Serbia's measure to support industry. The regulation on the terms and conditions of attracting investment precisely lays down the conditions for granting investment aid. Similarly, priority target sectors have been identified, though the selection criteria remain unclear. A track record needs to be established showing that aid is attributed according to a transparent procedure and to the best projects in terms of competitiveness and sustainable development. The conditions for granting aid to the projects of special importance remain opaque. The attribution of aid should be de-politicised and based only on socio-economic criteria.

Services sector development

Further development of the services sector is inhibited by non-transparent administrative requirements for the provision of services, the low share of e-commerce, a lack of skills and knowledge required for complex services and an underutilised tourism potential. A diagnostic of the challenges of the services sector is included in the programme; however, there is no service-focused planned response. As the majority of the economy is in services, most of the horizontal measures of the ERP will have an impact on their improved functioning. In particular, services provided by SMEs would benefit from a better registry and a modern regulation of e-commerce. The tourism strategy is being implemented, but its priority concerning restructuring of public spas has progressed only slowly.

Business environment and reduction of the informal economy

There are still significant barriers to businesses to attract and facilitate private investments. Little progress has been achieved in advancing business-friendly reforms since the simplification of the procedure for issuing construction permits in 2015. The continuing barriers to private investment include a costly, unpredictable and non-transparent system of parafiscal charges, difficult access to capital for smaller firms and red tape. Competition remains distorted by state-owned enterprises and the high share of informal economy. Despite some progress in restructuring state-owned enterprises, 166 remain in the privatisation portfolio. They employ 52,000 workers and include some of the largest strategic companies. Their resolution should be completed within a reasonable period, in particular for those companies that still represent a significant cost or fiscal risk for the State budget. The ERP provides a comprehensive analytical part listing all the relevant shortcomings of the business environment in Serbia.

The rolled over measure on improving access to finance for SMEs remains a priority and needs to be put into place with fewer delays than so far. As part of their macroeconomic stabilisation efforts, the government and the central bank have addressed many issues concerning access to finance for SMEs. The main remaining challenges include strengthening equity finance providers, making EU-based funds easier to access, and putting risk capital in place to support SMEs and start-ups. The measure deals with

these challenges and proposes to develop a regulatory framework for microfinance. However, there is no information on how this new microfinance regulation could help the market and whether there is interest among financial institutions to engage in such lending. In addition, the regulatory framework for new financial instruments, such as venture capital funds, crowdfunding, etc., also needs to be upgraded.

The measure reforming public utility companies is of high importance but its implementation continues to be a challenge. The framework for introducing corporate governance is in place and now needs to show concrete results in terms of de-politicisation and merit-based recruitment of top management. Genuine progress has been achieved in restructuring Serbia railways: its workforce is being reduced on a voluntary basis, unprofitable lines are being closed and private operators' access to the rail infrastructure has become effective after the unbundling of the company. Following the adoption of a financial consolidation plan in February 2016, payment collection by Srbijagas has improved. However, its debt is significant and still needs to be restructured. A plan to optimise the workforce of the public electricity utility EPS' was put in place, but the company needs to strengthen its management, further improve collection rates and adjust electricity prices to further improve its financial performance. Financial compensations have helped to mitigate the social effects of these reforms. Their finalisation remains essential in order to ensure the long-term viability of these public utilities. The restructuring of the other utilities, in particular large loss-making ones such as Roads of Serbia, should be considered as well.

The rolled-over measure to reduce the administrative burden for businesses through a reform of parafiscal charges has faced significant implementation delays. The programme advances a plan to establish a unified system of public registry of administrative procedures for doing business, but no meaningful progress in its implementation has been achieved yet. While this mapping exercise will increase transparency and thus facilitate businesses' compliance with administrative requirements, the main challenge will be to ensure that this also results in simplification of the identified procedures. No progress has been made on reforming parafiscal charges. The law on fees, planned for adoption in 2016, is still under preparation. It should aim at increasing the transparency of parafiscal charges and rationalising and reducing them effectively.

The scope of the proposed measure to fight the informal economy is too narrowly defined. The programme envisages establishing a common information platform for all inspections (e-inspection), but this is only one of the possible measures to combat the informal economy. In addition, further progress is needed to ensure the deployment of this platform by 2018. This platform should be completed by a proper risk assessment system ensuring that inspections are better targeted. Alignment of the general Law on Inspection with the relevant sectoral laws is also needed to improve the efficiency and predictability of the system of controls. A more comprehensive reform would better contribute to the fight against the informal economy and informal employment while reducing the costs of unnecessary and frequent inspections.

Research and innovation

Cooperation between the public and private sector is weak and not systemically supported. The ERP analysis is clear and identifies the main weaknesses and obstacles to innovation. There is increasing interest in finding ways to improve research cooperation between the public and private sectors; this is also reflected in the recent adoption of the Research for innovation strategy. However, so far, the majority of public

funds for research end up in research institutes while companies receive a very small share. The public institutions have opened technology transfer offices and new science parks have been established, both with the aim of supporting high tech start-ups. The Ministry of Science established the Innovation Fund which has shown how support instruments should be prepared and implemented. However, it is lacking the critical amount of funds to have a systemic impact. Significant efforts are required to further support innovation.

The focus of the measure to improve cooperation between public and private innovators mainly via financing of the Innovation Fund is too narrow. The majority of funds will continue to be disbursed through old structures that are not presented in the ERP. The innovation system needs transparency and predictability, so that its good practices can be mainstreamed and bad ones abolished. A multiannual action plan for implementation of the Research for innovation strategy is therefore needed. The finalisation of the smart specialisation process will provide further guidance on capacities for innovation that merit increased public support. The linkages to growing export and diversifying high technology sectors would become more visible. A proper system of support for innovative firms could help reduce the brain drain. According to a recent survey by the Statistical Office, 15% of all current Serbian migrants leave Serbia with the ambition of studying and later finding a job abroad. The ideas proposed for improving the innovation environment in the law on higher education seem largely appropriate.

External trade and investment facilitation

The Serbian economy still has a relatively low level of trade openness and integration into European industrial value chains. Determined political and technical action is needed to work better with incoming investors so that they can develop the country's potential to expand to other markets. For example, more reflection is needed on how to support clustering of companies around existing FDI, which has so far only started in the automotive sector. Similarly, the ongoing programmes to internationalise SMEs need to be stepped up and expanded to a greater number of beneficiaries.

The measure to improve the national quality infrastructure system is relevant to tackle technical barriers to trade, but more ambitious measures could be considered in order to further boost external trade. A thorough review of all legislation, technical regulations and standards still needs to be completed. So does the removal of distortive non-tariff barriers to trade that do not derive from the use of certificates of conformity, standards or other technical requirements. The national referencing laboratory is not yet fully functional. Trade with the EU could also be further facilitated by removing unnecessary costs at borders and beyond border, in a similar manner as envisaged by the Central European Free Trade Agreement's ambitious trade facilitation agenda. In parallel, and as underlined in last year's assessment, better services could be offered to help companies, in particular SMEs, to internationalise. This could be done through consultancy or participation in international fairs.

Education and skills

The education system in Serbia faces key structural challenges at all levels. The ERP diagnostic highlights the lack of pre-school education for 3-5.5 year old children; kindergarten enrolment is 52% in 2016 compared to the national Education Strategy target of 75% by 2020. Outdated teaching methods and curricula in primary and secondary education lead to low basic skills levels among 30-40% of pupils, as evidenced by PISA results. Vocational education and training and higher education are

often not adequate for a swift transition to the labour market; recent studies point to up to three years long transition periods.

The development of a National Qualifications Framework (NQF) and its implementation through a review of occupational profiles has advanced at a rather slow pace. The measure is partly rolled over into the 2017-2019 ERP, but the main step for enacting the whole reform package, the drafting and adoption of a legal base for the NQF compatible with other relevant legislation and supplemented by secondary legislative provisions on operational and institutional arrangements, foreseen in 2016, is not yet completed. Work on defining occupational profiles is undertaken in ad-hoc projects with external expertise, but lacks a structured involvement of the business sector and Social Partners, which is indispensable for the success of the reform.

In this year's ERP, the measure on the NQF has been expanded to include a new component for establishing a national model of dual and entrepreneurial education. This model is based on two pillars, introducing entrepreneurship education elements in the general education system during years 5-9, and apprenticeship-type vocational training as an alternative to school-based training. It has a potential to close the skills gaps in the future and to improve the labour market integration of young people and should be aligned to the ongoing development of the NQF, which similarly foresees the definition of occupational profiles. However, the ERP does not include a timeline for the measure, and the budgetary implications appear unrealistically low.

Employment and labour markets

Despite some positive developments, the labour market continues to be characterised by low activity rates, low level of skills and skills mismatches. The unemployment rate fell by 2.4 pps to a still high 15.3%, while activity and employment rates increased. Although most of the gains were in informal employment, related mainly to agricultural activity, there was also a noticeable increase by 3.4% of formal employment. The diagnostic presented in the programme is primarily focussed on the key labour market indicators and on supply-side factors, such as education, while other root causes for the generally still low labour market participation (around 53% for the population above 15) are not explored.

The demographic trends with a declining and ageing population require further stimulation of labour market participation and labour demand. Improving prospects for young people is particularly important in this regard. Serbia should envisage addressing structural problems in the labour market, including informality, through systemic reforms going beyond the provision of active labour market measures for the unemployed. Potential areas for reform are the high tax wedge on labour at the lower end of the earning scale and the level of the minimum social security contribution applicable to all formal jobs, irrespective of whether they are full or part time.

Raising labour market participation should be supported by more intense activation and mediation services. The measure on improving active labour market policies is rolled over from last year's ERP and has so far only been partially implemented. The budget for active labour market measures in 2017 remains stable compared to 2016. A large part of active measures is of rather general supportive nature. More tailor-made programmes responding to labour market needs should be envisaged.

Social inclusion, poverty reduction and equal opportunities

The level of income inequality is higher than in all EU countries. The GINI coefficient in Serbia is 38.2 (2015) compared to the EU-28 average of 30.5. The Poverty

Map of Serbia established in 2016 by the Statistical Office and the World Bank shows strong regional discrepancies. The poverty risk is at least two times higher in nearly all of the country compared to the capital, and in the South-eastern part it is up to four times higher. The ERP identifies this challenge to a limited extent. More attention should be paid to the intergenerational inequality in Serbia. Children and young people under 25 years have the highest risk and incidence of poverty, whereas poverty risk is lowest for older people.

The coverage and adequacy of social benefits is not satisfactory. The reform measure included in the previous ERP on improving the adequacy, quality and targeting of social protection measures will continue over a prolonged time frame until 2019. The measure includes two main components. A number of administrative measures will be taken to improve the targeting of eligible beneficiaries and the offer of social services at local level. The level of benefits for some specific categories of beneficiaries is planned to be increased, which requires legislative changes. For this purpose, a new Law on Social Protection is envisaged to be adopted in 2017. These changes would be beneficial to some smaller target groups, but are not likely to have a more widespread and substantial effect of alleviating poverty.

ANNEX 1: IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2016

2016 policy guidance	Summary assessment
PG 1: Further strengthen fiscal consolidation by using any excess revenue and current expenditure savings, and take additional measures, if needed, in order to achieve a primary surplus in 2016 and reduce overall budget deficits in the following years.	Serbia has **fully implemented** PG 1: • The 2016 primary surplus was 1.7 % of GDP, surpassing by far the initially planned deficit of 0.4 % of GDP. The 2017 ERP targets much lower deficits over the medium term than last year's programme.
PG 2: Support fiscal consolidation by taking steps to find a sustainable resolution of the remaining state-owned enterprises and continuing the organisational and financial restructuring of large utility companies. Advance the reform of the public administration as envisaged. Further improve revenue collection in a systematic and business-friendly way by implementing the tax administration transformation programme.	Serbia has **partially implemented** PG 2: • Around two-thirds of the companies in the portfolio of the former privatisation agency have been resolved through privatisation or bankruptcy. However, some large and strategically important enterprises, which represent significant fiscal risk, have not been resolved yet. • The organisational and financial restructuring of large utility companies has advanced unevenly. While successful steps were taken in the case of the railways, the reform of EPS and Srbijagas lags behind. • The public administration reform advanced as well, although it continues to suffer implementation delays. • Revenue collection improved significantly in 2016, despite major delays in implementation of the tax administration transformation programme.
PG 3: Continue to address risks to financial stability and the real economy by following-up on the NPL action plans which have been adopted, reinforcing the strategy already in place to promote the use of the local currency ('dinarisation strategy') in the financial system and shedding increased light on the asset quality of smaller banks that were not covered by the special diagnostic studies. Throughout this process, the central bank's monetary policy stance may remain accommodative insofar as both inflation expectations remain anchored and a favourable fiscal consolidation path is maintained.	Serbia has **partially implemented** PG 3: • The monetary policy stance remained accommodative, supported by low inflation expectations and continued strong fiscal consolidation. • The implementation of the NPL resolution strategy and action plans have helped reduce the NPL ratio by 4.5 percentage points to 17% in 2016. • No new steps were taken to provide additional information on the asset quality of smaller banks. • Existing efforts to promote the use of the local currency have continued but no new measures were taken.
PG 4: Address the under-execution of public capital expenditure by improving its prioritisation and management; as a priority, make significant progress in the preparation of the construction of the Bulgaria-Serbia gas interconnector project and finish road works on Corridor X by end of 2017.	Serbia has **partially implemented** PG 4: • The preparation of the construction of the Bulgaria-Serbia gas interconnector has progressed. The spatial plan for the gas corridor has been adopted. The new Memorandum of Understanding between the governments of Serbia and Bulgaria were signed. • Road works on Corridor X have progressed but have not been finalised. The causes for the delay are design deficiencies, land expropriation and the inefficiency of the contractor. • A draft decree on the content, method and assessment of capital projects is being prepared,

	but the first draft has not addressed all challenges in this area.
PG 5: Improve the business environment and promote private investment by developing a more transparent and less burdensome system of para-fiscal charges, putting in place a guarantee scheme for loans to SMEs and re-launching the 'regulatory guillotine.'	There has been **limited implementation** of PG 5: • There was no progress in the regulation of parafiscal charges. • The regulatory guillotine has not been re-launched. • The preparation for a guarantee scheme has advanced. The scheme, financed by the European Investment Bank, will be in place later in 2017.
PG 6: Step up the provision of targeted active labour market policies to facilitate in particular the reintegration of workers made redundant in the resolution of state-owned enterprises and public administration rightsizing. Increase the capacity of the National Employment Services to roll out such measures to larger numbers of beneficiaries.	Serbia has **partially implemented** PG 6: • The budget for active labour market measures is stable over 2016 and 2017 and has allowed for an increase in the number of beneficiaries compared to earlier years. • The functional review of the National Employment Agency has been finalised and has increased the capacity of local employment offices to provide client-oriented services.

ANNEX 2: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government adopted the economic reform programme on 3 March 2017 and formally submitted it to the European Commission on 20 March 2017.[2] The programme is in line with the medium-term fiscal strategy and the 2017 budget and covers 2017-2019. In conformity with the new approach to economic governance, the programme includes an expanded description of structural reform priorities. However, the programme's structure does not always fully follow the guidance provided by the Commission.

Inter-ministerial coordination

The programme was prepared with the involvement of key line ministries, although some of the reforms do not necessarily reflect their latest internal documents and priorities.

Stakeholder consultation

A public consultation was organised at short notice and at a late stage just before the adoption of the programme. Therefore, stakeholders could not influence the prioritisation or the content of reforms. This reduces the ownership of the reforms and the potential for their successful implementation.

Macroeconomic framework

The programme presents a clear and concise picture of past developments. It also covers all relevant data at the time of its drafting. The macroeconomic framework is sufficiently comprehensive and coherent. The macroeconomic scenario is plausible and major uncertainties and risks are clearly outlined and recognised. The programme also presents an alternative macroeconomic scenario, envisaging a lower growth path and slower narrowing of the budget deficit.

Fiscal framework

The fiscal framework is based on the presented medium-term macroeconomic scenario and is coherent, consistent, sufficiently comprehensive and integrated with the overall policy objectives. Revenue and expenditure measures, underlying the fiscal scenario are well explained. The programme would have benefited from integrating the identified fiscal space in the baseline fiscal scenario and incorporating the envisaged assumption of restitution related debt in 2018. The section on fiscal risks has been expanded and provides an elaborate analysis. The programme does not present long-term projections of population trends or of the implications of an ageing population on the labour market and public finances, in particular on health and pension systems. Significant further efforts would be needed to make fiscal data compatible with ESA 2010, the European system of accounts.

Structural reforms

The structural reform measures are based on credible diagnostics with indications of progress in the reforms and in particular the policy guidance from the previous ERP cycle. The measures are focused and planned with good detail; however, their scope of

[2] The authorities submitted the programme to the European Commission informally on 17 February 2017.

ambition often refers to a single procedural reform rather than a systemic long-term reform. In view of this, budgetary contributions are assessed realistically but remain modest and cannot support long-term growth.

The number of reforms is in line with the guidance note, but the length far exceeds the requirement of maximum 40 pages. Tables 9-12 in the annex are filled in appropriately. The Commission's 2016 guidance note states that individual infrastructure projects should be kept separate and not as sub-measures of one large measure. The ERP does not adhere to this request.