WORLD BANK GROUP

SERBIA'S NEW GROWTH AGENDA

FORGING A NEW FUTURE

Serbia's New Growth Agenda

Overall objectives

Serbia is at a crossroads. Although current growth rates are improving incomes, they are not bringing the country closer to average living standards in the European Union fast enough. The current 3 to 4 percent growth per year is at the upper end of Serbia's current potential growth. To reach European levels of prosperity, Serbia must embrace a new, ambitious agenda for reform.

Macroeconomic stability and the success of past reforms form the foundation for new, ambitious reforms

Serbia has shown that it can successfully complete a comprehensive reform program. As recently as in 2014, skeptics would have dismissed the likelihood Serbia would, in 3-5 years, turn a deficit of 6 percent of GDP into a surplus, nearly halve unemployment from almost 20 percent to 13 percent, or slash public debt from 67 to 54 percent of GDP. The country has also implemented a series of reforms to open up the economy, stabilize the financial sector, reform regulations for doing business, privatize or otherwise resolve over 2,000 state-owned enterprises, and make the labor market more flexible.

The New Growth Agenda challenge

Supported by sustained effort to maintain macroeconomic stability, Serbia could grow at 7 percent a year, doubling its income in 10 years. Acknowledging that this vision is highly ambitious, the New Growth Agenda outlines seven key areas for urgent and comprehensive action:[1]

- **Boosting investment.** Increasing public investment to at least 5 percent of GDP and facilitating private investment to above 20 percent of GDP annually, would support stability of high growth rates. Ensuring quality is essential as well.
- **Financing for growing firms**. Increasing credit to the private sector to a level closer to European benchmarks, including by enabling new financing instruments, would expand finance to young, small and medium enterprises, the new generation of firms. This could promote annual real GDP growth by about 1.3 percentage points.
- **Skilling workers**. With over two-thirds of firms failing to find workers to implement expansion, improving education quality to produce skills relevant for the private sector could increase GDP growth rate by up to 1.3 percent.
- **Raising productivity**. Increasing firm-level productivity and its annual growth from current low levels would enable higher value-added production, more jobs, and higher wages. A one percent increase in productivity could lead to one percent increase in GDP.
- **Promoting exports**. Serbian exporters are on average twice as productive as other firms; increasing exports from 50 to 80 percent of GDP would boost growth. Improving infrastructure and removing behind-the-border constraints would increase both exports and FDI.
- **Enabling business**. A better regulatory framework, including improved predictability and transparency of administrative procedures, could reduce costs for business by 0.9 percent of GDP annually. Better enforcement would strengthen business practices in private and public sectors.
- **Unleashing competition**. Reducing government presence in the economy, especially through less ownership of or favorable treatment of SOEs, would reduce barriers to competition, eliminate distortions, and could save at least 1 percent of GDP in public funds for more productive use.

For the *New Growth Agenda* to succeed, Serbia will need bold political commitment and strengthened government effectiveness and accountability.

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1 Growth impacts are based on model simulations.

Boosting Investment

Overall Objective:

Achieve an overall investment level of at least 25 percent of GDP annually—public investment of about 5 percent of GDP and private sector investment of over 20 percent of GDP—to sustain high growth.

Achievements in this area:

1. In recent years, the **government increased public investment**, from 2 percent of GDP in 2013 to 3.9 percent in 2018, and is expected to grow further in 2019, as it successfully completed the fiscal consolidation program.
2. A set of regulations dealing with **public investment management was adopted** in 2019 which will help to further increase public investment and efficiency of investment expenditure.
3. The **savings rate has been increasing**, now on par with the other Western Balkan countries at around 19 percent of GDP.

Challenges:

1. **Overall investment remains low** at 19.4 percent of GDP (average 2015–18), of which 17 percentage points is from the private sector. In 2019, overall investment is projected at 23.2 percent of GDP, still significantly below the 25 percent of GDP recommended by the Growth Commission for sustained long term growth.
2. **Domestic private investment is particularly low** at 17 percent of GDP. On average, over the last decade, Serbian domestic businesses annually invested 2.7 percent of GDP less than other Western Balkan countries and 5.9 percent of GDP less than other Central Eastern European countries.
3. Over the last decade, **public investment was 3 percent of GDP**, about 1.3 percentage points lower than the Central and Eastern Europe regional average and even more striking, this is 2.2 percentage points lower than the Western Balkans regional average.

What if…

… Serbia had achieved rates of public investments similar to other Eastern European countries since 2001 (4–5 percent of GDP)? Its annual growth would have been more than 1 percentage point higher and the size of its economy a quarter larger today.

Recommendations:

1. **Increase public investment** in growth-enhancing infrastructure to around 5 percent of GDP, which is the average for neighboring countries.
2. Fully **implement the public investment management** regulations and adopt missing bylaws.
3. **Adopt policies that promote private investment** to enable it to rise to over 20 percent of GDP. For example, reform tax policy to improve treatment of small and medium enterprises and entrepreneurs to ensure even applicability of tax rules across the country and across sectors; ease foreign exchange operations to allow for more capital inflows in the country and expansion of Serbian business abroad; and allow for additional innovative sources of financing including operational leasing and online solutions.

Financing Growing Firms

Overall Objective:

Deepen and diversify the financial sector to improve access to fit-for-purpose financing for small, young and innovating firms to enable growth and job creation.

Achievements in this area:

1. The financial sector has recovered from the global financial crisis with **capital adequacy and liquidity levels** in line with the EU.
2. **Non-performing loans dropped** by over 15 percentage points since 2014, to 5.7 percent at end-2018.
3. Progress has been made in **reforming state-owned financial institutions** with the strengthening of *Banka Postanska Stedionica* and the successful privatization of *Jubmes Banka*; however more remains to be done, including completing the privatization of *Komercijalna Banka*.

Challenges:

1. **Financial intermediation lags behind the EU and the financial sector is not diversified.** The private sector credit-to-GDP ratio is about 44 percent in Serbia, compared to 80 percent in the EU.
2. **Start-ups as well as micro, small, and medium-sized enterprises** face limited financing options as banks—which account for over 90 percent of financial sector assets—have requirements these firms cannot meet. Development Finance Institutions and current support programs are largely ineffective at enabling private-sector led growth.
3. **The contribution of capital markets to financing the economy is negligible.** The non-government markets in particular are shallow and underdeveloped, the institutional investor base is weak, and there are few companies able and willing to issue securities.

What if…

… Serbia doubled its private sector credit relative to GDP? Annual real GDP growth could increase by about 1.3 percentage points.

Recommendations:

1. **Improve private sector financing** through stronger legal frameworks and enabling environments for alternative financing instruments such as factoring, leasing, private equity/venture capital, international financial transactions, introduction of innovative financial services, and microcredit.
2. **Reform the development finance framework**, based on an approved strategy, and consider setting up a partial credit guarantee facility for lending to start-ups and micro-enterprises in line with international best practices.
3. **Reignite capital market development** by improving the operations of government bond and money markets while developing a strategy for increasing the institutional investor base.

Skilling Workers for Growth

Overall Objective:

Improve workers' skills available for the private sector and facilitate employment transitions in order to increase productivity and growth potential.

Achievements in this area:

1. Serbia's **employment recovered to pre-crisis levels**. 240,000 jobs were created in 2014-2018, and unemployment declined from 19.9 to 13.3 percent, one of the lowest in the region.
2. Serbia **improved the flexibility of the labor market** through reform of fixed-term contracts and employment termination under the 2014 Labor Law.
3. Several **Vocational Education and Training (VET) profiles were modernized** and some 600 companies participated in dual education, thanks to the Laws on Dual Education. **Enrollment in higher education increased** from 40 percent in 2001 to 58 percent in 2017.

Challenges:

1. **Only 57 percent of Serbians aged 15–64 are working,** compared to 67 percent in Central and Eastern Europe. Also, a Serbian worker in manufacturing produces roughly three-quarters (by value) of what a worker in Czech Republic and Hungary produces.
2. **Finding workers with the right skills** is increasingly a constraint on firm growth. 30 percent of companies in 2017 indicated problems with finding new workers, mostly due to skill shortages, up from 13.7 percent in 2014. Serbia has one of the **highest shares of students in upper secondary VET** instead of general education in the region (74 percent), with higher cost and significant mismatch between student demand for VET programs and the supply of spaces.
3. **Labor taxes are high**, and particularly high for low-wage earners and those with dependents when compared with EU and OECD countries. **School-to-work transition and job matching** are held back in part by the lack of flexibility in active labor market programs to adapt to changes in demand and to scale up effective interventions.

What if…

… Serbia could improve education quality to produce skills relevant for the private sector? This could increase GDP growth by 1.3 percentage point annually.

Recommendations:

1. **Reduce non-wage costs** and increase the progressivity of labor tax and social security contributions to foster more participation of low-wage workers and workers with dependents in formal employment.
2. **Reduce the proportion of students going through VET** in areas where labor market demand is low and continue modernization of curricula at the secondary level; **develop quality assurance systems** and facilitate the growth of dual education in higher education.
3. **Implement a monitoring and evaluation system for Active Labor Market Policies (ALMPs)** and give Public Employment Services the authority to quickly adapt ALMPs based on evaluations and analyses of the latest labor market needs.

Raising Productivity

Overall Objective:

Double productivity growth from 1 to 2 percent a year.

Achievements in this area:

1. Since 2008, **productivity of firms has been growing** and the allocation of capital and labor among firms improved over time.
2. The recent **success in *net* job creation** was driven by new firms (96 percent of net new jobs), high-growth firms (77 percent), and was largely in services (70 percent).
3. **Foreign direct investment has brought many new jobs** (40,000 since 2011) and established new industries in Serbia (notably the motor vehicles industry). FDI firms have also created positive productivity spillovers to the firms supplying them or those in the same industry.

Challenges:

1. **Productivity is low and slow-growing**, at less than 1 percent annually. Serbian manufacturing firms are three times less productive than the average EU firm; and a state-owned manufacturing firm is a quarter less productive than an average private firm in its sector.
2. **High-growth firms are only 5.3 percent of all firms**, compared to 25 percent in Lithuania and 45 percent in Latvia. Yet, these are the most productive firms: a top 20 percent most productive firm is four times more likely to be high growth than a firm in the bottom 20 percent. Key constraints to the expansion of the most productive firms are over-regulation, excessive state involvement in business matters, low competition, and capital and labor market frictions/ exclusion.
3. Only a **small group of firms drove employment growth**. The so-called high-growth firms that make up only 5 percent of firms in Serbia contributed 77 percent of net job creation between 2014 and 2017.

What if…

… productivity in Serbia increased alongside doubling the proportion of high-growth firms from 5 to 10 percent? This boost in productivity and high-growth firms would mean higher employment, better wages and higher production.

Recommendations:

1. **Business environment reforms remain critical**. These reforms would be mainly in competition and product market regulation; reducing distortions in access to financing, especially for SMEs and start-ups; further removal of labor market frictions; and removing sector-specific distortions.
2. **Rethink FDI policies beyond job creation** to foster FDI that creates long-term linkages between foreign and domestic firms and maximizes knowledge spillovers.
3. **Reduce and reorient state aid**. A drastic reduction in state aid (by 1-1.5 percent of GDP) and redirecting resources to more productive use (such as public investment) would increase growth. Since current subsidies are mostly directed at keeping afloat less productive state enterprises, this would improve factor allocation, leading to overall productivity growth. The remainder of state aid should be directed at mitigating market failures, such as lack of access to finance for young and small firms.

Expanding Exports

Overall Objective:

Raise Serbia's exports from 51 percent of GDP to the 80 percent, level of similar Central and Eastern European countries.

Achievements in this area:

1. **Serbia reduced tariffs** and eliminated most of non-tariff barriers to trade and is working on further trade facilitation measures.
2. As a result, Serbia's **exports of goods and services grew** to almost 51 percent of GDP in 2018, and is expected to increase further in 2019 as share of GDP. Serbia is also exporting more products and has converged with the diversified EU export basket in the medium-skill technology segment.
3. **Services exports have grown** to 14.3 percent of GDP in 2018, with annual growth rates of 27.2 percent in computing and 11.5 percent in professional services.

Challenges:

1. **Exports are diversifying too slowly.** The diversification in the medium-skill technology segment was significant but concentrated in a few products, with only 47 new products emerging (net) during 2008-2017 in the entire goods export basket. Croatia and Lithuania expanded their exports by 201 and 312 new products, respectively. No convergence in the diversification of products produced for exports in the high-skill technology segment has occurred.
2. The **export-supporting services sector and ICT infrastructure are weak.** The quality and competence of transport, warehousing and brokerage services is below that of other Western Balkan countries, constraining connectivity to markets.
3. **Global technology trends and tough competition** in export markets could negate the modest gains that Serbia has achieved. Domestic export policies need to be as enabling as possible to maximize exporters' ability to produce and to minimize regulatory hurdles.

What if…

… Serbia further decreased tariffs? This would bring an additional 0.1 percent to the annual growth. Elimination of behind-the-border constraints to exports could bring much higher benefits.

Recommendations:

1. **Improve the operating environment for exporters.** Eliminate tariffs on raw materials and non-tariff restrictions, reduce the cost of documentary and border compliance, and improve efficiency of border control agencies; improve quality of transportation and communication infrastructure.
2. **Develop capabilities and export-supporting services.** Reorient export promotion from attracting export-oriented investment from abroad toward facilitating the development of domestic exporters. Facilitate acquisition of managerial and technical skills among firms and qualified suppliers, as well as scientific and technological services supporting manufacturing industry production tools, such as advanced ICT.
3. **Improve the general business environment.** Strengthen the capacity of the courts to reduce the time and cost of enforcing contracts, among other business-enabling reforms that are important for exporters and their clients.

Enabling Business

Overall Objective:

Complete regulatory reforms to reduce administrative burdens on business and improve predictability and transparency of administrative procedures.

Achievements in this area:

1. In recent years, the country's **ranking on the Doing Business list** has significantly improved (from 93rd position in 2013 to 44th in 2019). Serbia is doing especially well when it comes to dealing with construction permits and starting a business.
2. **Regulatory reform is underway.** More than 2,500 state-level procedures that affect businesses have been identified, 1,750 are currently being simplified and 100 are being digitalized.
3. Procedures have been put in place to ensure **predictability of new legislation**, regulatory impact assessments, and public consultations.

Challenges:

1. Despite overall good progress, **Serbia lags on some aspects of the Doing Business indicators**. These reflect deeper structural issues, such as governance and competition, which have a sizeable impact on business operations, especially for domestic SMEs.
2. **Lack of predictability and consistency in the business and administrative environment** is a key challenge, especially for SMEs. Processes related to issuance of various permits and licenses are not always systematic and SMEs not fully certain on what is required.
3. **Less than one percent of the government's firm-level programs** for SME competitiveness and innovation (which in 2017 totaled approximately €142 million) **targets market linkages**.

What if…

… Serbia improved predictability and transparency of administrative procedures and removed regulatory barriers? This could add up to 1 percent to growth annually. Better SME policies could help local SMEs be better equipped to supply large companies, a growing market of well over €1 billion annually.

Recommendations:

1. Continue and complete the process of **optimization and digitization of administrative procedures.** Make publicly available all administrative requests and administrative procedures.
2. **Complete the unfinished legislative reform agenda.** Streamline the foreign exchange legislation by adopting a new, simplified law. Complete the reform of para-fiscal charges by establishing a public register of such charges, eliminating double charges, and prohibiting charges that are not in the register, including those introduced by municipal utilities. Update labor law, including on income taxation, to accommodate "mini" and part time jobs.
3. **Reorient SME support programs to focus on firm upgrading and market linkages.** Emphasize improvements in managerial skills and practices, innovative capacity of firms, and technology adoption. Facilitate market linkages, particularly by assisting domestic exporters to connect with foreign markets and global and regional value chains. Enhance the framework for export promotion and market intelligence.

Unleashing Competition

Overall Objective:

Ensure fair competition among enterprises to encourage most productive allocation of resources to boost growth.

Achievements in this area:

1. Serbia **developed antitrust institutions**. The Competition Law has been in effect since 2005 and was updated in 2009 and 2013 to align it with EU standards. The Commission for Protection of Competition enforces the law, independent of the government.
2. Serbia **privatized over 2,000 SOEs**. The state has reduced its footprint in the economy and enabled the private sector to operate in many sectors. The antitrust commission promotes a level playing field between private and public firms by taking on SOE cases.
3. Serbia took first steps to promote **competition in network sectors**. Serbia has made efforts to unbundle some vertically integrated companies and to control state aid, and initial reforms have taken place in energy, transportation and telecommunications.

Challenges:

1. The **restrictiveness of Serbia's product market regulations** (average score of 2.10 on the OECD index) is higher than in 23 EU countries (average of 1.34) and all former Yugoslav republics (average of 1.76).
2. The **playing field is unlevel for private firms**. State aid is high, even though some aid is not reported and reviewed in line with the State Aid Control Law. A large portion of aid is directed to some 600 SOEs, holding back development in sectors in which private sector operations are viable. SOEs also benefit from regulatory protection and weak enforcement.
3. **Antitrust enforcement is misbalanced.** The Antitrust Commission reviews mergers outside of Serbia and charges firms high review fees, creating an independent source of income but burdening the private sector without leading directly to stronger enforcement in Serbia.

What if…

… Serbia could reduce state aid to the EU average level? This would free up at least 500 million RSD (1.5 percent of GDP) for more productive use, such as investments into roads and railways.

Recommendations:

1. **Ensure a level playing field between SOEs and private firms** by reducing state aid, strengthening state aid control, privatizing or corporatizing remaining SOEs, and insulating the rulemaking process from capture.
2. **Complete market reforms in services** by unbundling entities and liberalizing tariffs in gas and electricity, improving network access and fixed line number portability in telecom, and lowering entry and conduct barriers in transport, pharmaceuticals and professional services.
3. **Rebalance antitrust regulations and enforcement** by focusing on mergers in Serbia and strengthening efforts to detect and investigate cartels and anticompetitive agreements, particularly in public procurement.