Contents

Executive Summary 3
The urgency for a New Growth Strategy 7
Boosting investment 17
Financing growing firms 21
Skilling workers for growth 25
Raising productivity 31
Exporting to grow 37
Improving the business environment 41
Unleashing competition 47
Forging a new future 55
The Serbia Country Economic Memorandum (CEM) and associated papers discuss the potential and reforms to boost Serbia’s growth to 7 percent a year and double income per capita in the next decade.

The team was led by Ekaterina Vostroknutova, Trang Van Nguyen, and Lazar Sestovic, and consisted of Dusko Vasiljevic (private sector development, state aid, and exports), Gunhild Berg (financial sector), Elwyn Davies (productivity and firm-level analysis), Maciej Drozd and Tania Begazo Gomez (competition), Jaime Frias (exports), Bojan Shimbov (exports and state aid), Alexandria Valerio and Katia Herrera Sosa (skills), Gonzalo Reyes Hartley (labor market), Natasha Rovo (structural reform analysis), Marc Schiffbauer (state aid), Shawn Tan (state aid and FDI spillovers), and Verena Fritz (governance). The external communications team included Vesna Kostic, Mirjana Popovic, and Artem Kolesnikov. Administrative and operational support from Miroslav Nesic, Leah Laboy, Zana Ivanovic, Aleksandar Pavic, and Jasna Vukoje is acknowledged with thanks. Carter Dougherty edited the main manuscript, while Anne Grant and Katherine Shafer Coleman edited the background papers. Design and typeset of the main report and accompanying materials were implemented by Florencia Micheltorena, Budy Wirasmo, Carlos Reyes, Maja Simonovic, Rajesh Sharma, and Lynn Saghir.

The CEM project was guided by Linda Van Gelder, Stephen Ndegwa, Gallina Vincelette, and the Western Balkans Country Management Team and has benefited from both internal and external reviews. The team is also grateful to a number of reviewers, inside and outside the World Bank Group, including Enrique Blanco Armas, Donato de Rosa and Paulo Correa.

Support from the Global Facility on Growth for Development financed by the Republic of Korea and support from the Good Governance Fund of the United Kingdom are gratefully acknowledged. The work has benefited from engagement with the Korean Development Institute, including the visit and discussions with Professor Yong-Seok Choi of Kyung Hee University and Dr. Sanghoon Ahn, Executive Director, Korean Development Institute Center for International Development. The team is also grateful to the British Embassy in Belgrade.
Background papers prepared for this report:

1. Structural reforms to set the growth ambition
2. Investment for growth
3. Financing for growth
4. Exporting to grow
5. Boosting productivity for faster growth
6. Encouraging FDI spillovers
7. Labor market for growth
8. Building a skilled workforce
9. Regulatory environment for private sector development
10. Removing regulatory barriers to competition
11. Reforming state aid for growth

This report and the accompanying background papers are available online at:
www.worldbank.org/serbia-cem
Serbia is at a crossroads. Although current growth rates are improving incomes in Serbia, 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 growth. Two decades ago, Serbia made the choice to leave behind years of war and rapidly reconstruct its economy. It curbed hyperinflation, and steadily restored broken infrastructure. Real GDP growth of 6.6 percent ensued, interrupted only by the global financial crisis. Now, as then, Serbia must be willing to set another high goal of doubling its income in a decade. Only strong political will, stemming from a broad consensus, can bring about the policies needed to achieve this.

Serbia can deliver on an ambitious reform agenda for growth as it has done before. Skeptics may argue it is unrealistic for Serbia to grow at 7 instead of 3-4 percent annually, or to generate 100,000 jobs each year, or to abandon the legacy of pervasive state control of the economy. But 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. Yet it did. Sustaining the success of these reforms underpins the foundation for the New Growth Agenda. Serbia can become a fast-growing, sophisticated modern economy, driven by its private sector, if it maintains the hard-
won gains of macroeconomic stability and advances the transformation in the following seven areas:\footnote{Based on model simulations, see Figure 2 and Box 2.}

**Boosting investment.** Investment, private and public, is an expression of confidence in the future, and higher levels of it will be both the cause and effect of higher growth in Serbia. An overall investment level of at least 26 percent of GDP would be needed to reach a 7 percent growth rate and to sustain it for a prolonged period of time. Based on historical patterns in similar countries, Serbia could add one percentage point to annual growth by increasing public investment alone to five percent of GDP. Considerably more could come from closing the gap in private investment, given that Serbia’s private sector invests nearly 3 percentage points of GDP less than firms in Western Balkan countries and nearly 6 percentage points less than those in Central and Eastern Europe. Ensuring quality of investment is essential as well, including reforms of the public investment management system.

**Financing growing firms.** The financial sector enables investment. Obtaining credit can be the difference between expansion or stagnation for small enterprises or start-ups that have innovative ideas and entrepreneurial drive. And in Serbia the financial sector lacks instruments that best suit their needs. Introducing new financing options and invigorating capital markets would help increase the ratio of private-sector credit to GDP, which is currently only half of the EU average. Achieving EU levels of financial intermediation would boost Serbia’s GDP by 1.3 percent annually.

**Skilling workers.** There is no better example of investing for the future than better education for Serbian children and youth. Ending functional innumeracy and illiteracy is not only the right thing to do but would also supply Serbia’s companies with better-trained workers. Labor inactivity remains high, more so among women and the Roma population. High labor taxes, particularly for low-wage earners, diminish work incentives. Reducing non-wage costs and making labor tax and social security contributions more progressive would foster labor participation. Over two-thirds of expanding businesses are unable to find workers with the right skills. A broad reform program to upgrade skills – from curricula reform to quality assurance systems – and evidence-driven active labor market policies would improve quality. These reforms could add 1.3 percent annually to GDP growth.

**Raising productivity.** The productivity of its private firms will in large part determine Serbia’s prosperity. With Serbia’s average firm productivity low (Serbian manufacturing firms produce only one-third of what EU firms do, using the same inputs) and slow-growing (less than 1 percent annually), there is much room for improvement – and with it, significant potential for Serbian firms to produce more, hire more people, and pay better. Domestic private firms are the backbone of the Serbian economy,
employing over half of the formal private labor force and exhibiting the highest recent productivity growth. Over three-quarters of net job creation between 2014 and 2017 was from only 5 percent of firms. Removing constraints to doing business, entry and competition should help increase the number of high growth firms. In the same way, policies that encourage competition, level the playing field and equalize access to finance, as well as improve skills, would allow for more labor and capital to flow to the most productive firms, increasing overall productivity in the Serbian economy. A one percent increase in productivity can bring an additional 1 percent increase in GDP. More productive firms have a better chance of competing internationally and bring best business practices back home.

Expanding exports. Exports of goods and services, an important component of Serbia’s success, grew from 30 percent of GDP in 2006 to over 50 percent of GDP in 2018. Over the same period, Serbian ingenuity and favorable policies have driven explosive annual growth rates in two service exports – 27 percent in computing and over 11 percent in professional services. But these two sectors account for a small share of the economy. For total exports to reach 80 percent of GDP, the level of similar small transition economies that have already joined the EU, Serbia needs policies that upgrade export-supporting services (e.g., better transport, warehousing and brokerage services, especially for domestic firms), and improve the operating environment for exporters (e.g., access to raw materials, cost and inefficiency of border compliance). A firm that exports is twice as productive as a firm that does not, a consequence of higher competition abroad. Low levels of investment in new technologies, issues with trade facilitation, and other behind the border constraints on potential exporters can prevent Serbian businesses from entering international markets or expanding exports.

Enabling business. Serbian enterprise, financial means, and skilled labor amount to little without the right environment to do business. A government approach of not only permitting but truly enabling business is essential. Changes to improve the overall business environment would find favor with any good-governance advocate: improved transparency of administrative procedures, simplification of overly complex laws, and improving governance and curbing corruption. But comprehensive execution has so far been elusive. Progress in this sphere could add 0.9 percent to GDP annually.

Unleashing competition. Competition policy needs not only to minimize anti-competitive business practices, but also to curb anti-competitive state interventions. International experience demonstrates that a comprehensive national competition policy can bring substantial economic gains, both economy-wide and sector-specific. In Serbia, 60 percent of distortions in product markets are introduced by government, especially by widespread state ownership and special treatment of SOEs – through subsidies, preferential access to credit, and protectionist regulation. In addition to removing these, Serbia also can unleash
competition by unbundling monopolies, leveling access to infrastructure, removing price controls, or curbing formal powers of incumbents in key sectors, such as energy, transport, telecommunications, pharmaceuticals, and professional services. Reducing and reforming state aid would bring significant benefits, but requires hard choices, notably redirecting a large share of support from unproductive state-owned enterprises to productive investment.

Along with maintaining macroeconomic stability, this policy agenda would constitute a national declaration that Serbia intends to seize the opportunity it has created for itself. None of this will come easy. In 2019, the global environment has deteriorated; leading indicators suggest a further slowdown in global growth and trade in the near term. But Serbia can safeguard its hard-won macroeconomic stability and take its economic transformation to the next level. Reforms will at once promote growth and build needed resilience for the coming period and beyond. But this goal will elude Serbia if it does not construct a better foundation for faster growth. The challenge is not only economic. It requires courageous, decisive and bold political commitment as well as strengthening government effectiveness and accountability.
Now is the time for Serbia to write the next chapter in its economic history for the benefit of current and future generations. After a period of retrenchment, Serbia has arrived at the point at which, in other small transition economies in Europe, a critical mass of reforms powered a higher rate of growth marked by sustained investment, productivity gains, and rising incomes. To enter that phase, Serbia needs a clear, and evidence-driven strategy for a new wave of structural change, while maintaining macroeconomic stability. With what we call the New Growth Agenda, Serbia has a shot at growing at 7 percent a year, well beyond the current 3 or 4 percent. This higher rate would double per-capita income in 10 years, benefiting Serbians soon, not in the distant future.

An effective growth strategy would build on the foundation of hard-won macroeconomic stability and the success of past reforms (Box 1). Since 2000, when Serbia introduced a strong reform program covering all areas of the economy, while rebuilding infrastructure destroyed by war, it had enjoyed periods of high growth. More recently, following the global financial crisis of 2008, it emerged from a decade of weak growth and a series of recessions and high debt and deficit levels, with a successful fiscal adjustment implemented in 2014-2017. Reforms included a reduction in public sector spending: wage and pension cuts, a hiring freeze, reduced spending on subsidies and guarantees to SOEs. In addition, reforms to flexibilize the labor market and to improve business regulations were also implemented. Since then, Serbia has enjoyed

2 The seven small transition economies of Europe (7STEEs), Bulgaria, Croatia, Estonia, Latvia, Lithuania, Slovak Republic, and Slovenia, are used for comparisons throughout this report.
five consecutive years of growth which reached 4.4 percent in 2018. Inflation is low, external account balance has declined to 5 percent of GDP thanks to strong exports, while fiscal accounts are in order, and the cost of borrowing is at historically low levels. Serbia has other strengths to build on, such as proximity to Europe-based global production chains, and a cost-competitive and skilled labor force. The time is right to demonstrate that past achievements and sacrifices helped create a foundation for changes that will bring citizens more lasting benefits.

Although current growth rates are improving incomes in Serbia, they are not bringing them closer to average living standards in the European Union (EU) fast enough. The 3-4 percent growth per year that Serbia is experiencing recently is at the upper end of its potential growth rate, and its GDP is at potential (Figure 1). Other small transition economies of Europe are growing and converging to EU income levels faster than Serbia. Only further structural reforms can boost potential growth.

Figure 1. Serbia has reached its potential GDP level.
(real GDP, constant 2010 dinar billions)

Source: World Bank staff calculations based on Statistics Office data using the HP filter methodology.

3 Although definitions and measurement differ depending on the horizon of projections and purpose of analysis, potential output is broadly defined as the level of GDP that an economy can sustain without stoking inflation.
The fall of Slobodan Milosevic in October 2000 left Serbia with an economy in near-collapse. International trade sanctions and policy malfeasance had driven output down to half the level of 1990. Inflation surged over 100 percent annually, while public debt reached 175 percent of GDP (Box Figure 1). Public infrastructure, ravaged by war and underinvestment, lay in disrepair. Power outages and food shortages were frequent, the private sector was small and banking system insolvent.

Changes to over 200 laws by the fledgling democratic government provided the legal basis for transformation. The closure of failed state banks and entrance of major foreign ones underpinned a cleanup of finance. Privatization of state-owned enterprises, over 2,000 of them, tackled the legacy of state control of the economy. Trade liberalization and better access to EU markets knit a once-isolated economy into the fabric of European commerce.

Box 1. Serbia’s journey: transition, reform, setbacks, and achievements

Box Figure 1: Serbia’s GDP is only now approaching its 1990 level.
(GDP index, 1990=100)

Box Figure 2: Post-2008 adjustment reduced all drivers of growth.
(contributions to GDP growth, p. p.)
Box 1. cont.

Real GDP growth averaged 6.6 percent from 2001 to 2008 but the global financial crisis proved to be an economic riptide that dragged the Serbian economy down in brutal fashion. Sources of financing dried up, leading to a significant drop in investment (Box Figure 2). Consumption also declined drastically, exposing the flaws of the pre-crisis growth model that had led to unsustainable debt levels. Political will for change ebbed, and even allowed some important policy reversals. Severe weather conditions – both floods and droughts – hit Serbia hard as well. As a result, GDP growth between 2009 and 2014 averaged 0.1 percent annually.

Serbia’s fiscal deficit averaged 5.2 percent of GDP over that period, driving an increase in public debt from 27 percent of GDP in 2008 to 67 percent in 2014. That year, Serbian leaders found the will to implement a 4-year fiscal stabilization program. High deficits of over 6 percent of GDP were turned into a surplus as of 2017 and public debt declined from its peak of 71 percent in 2015 to around 54 percent in 2018.

Since 2008, Serbia’s annual growth has averaged only 1.2 percent (Box Figure 1). As a result, its economy is still smaller than in 1990. Meanwhile, transition economies in Central and Eastern Europe (CEE) are now 80 percent larger than they were in 1990 and a group of small transition economies of Europe (7STEEs) are 60 percent larger.

Recently, growth accelerated, reaching 4.4 percent in 2018, its highest level over the last decade, and the macroeconomic environment is stable, with low inflation, balanced fiscal account, and declining external deficit. But despite these positive developments, numerous risks, both domestic and external, cloud the outlook. Possible policy reversals, when fiscal space is used to stimulate consumption instead of investment and growth (as has been the case with wages in the public sector), political division, or weak private sector response to incomplete or slow implementation of reforms (like in the case of utility companies) would reduce growth outlook. Domestic private sector is already investing much less than in other countries and these risks could reduce those investment even further. External risks, as a global slowdown in 2019 showed, can come unexpectedly and swiftly. Only through further structural reforms can Serbia build resilience to these global headwinds.

Source: World Bank staff.
Note: The 7STEEs are Bulgaria, Croatia, Estonia, Latvia, Lithuania, Slovak Republic, and Slovenia. The Central and Eastern Europe (CEE) for the purposes of this comparison include Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania and Slovakia (other countries excluded because of historic data availability).
What if Serbia pursued a reform plan to become like Germany in 20 years? In today's Europe, no country represents the frontier of economic success the way Germany does. Figure 2 shows the distance of Serbia from Germany on nine economic development dimensions and the simulated gains in annual growth of real GDP that closing the distance in 20 years would bring. (In the case of government effectiveness, the time frame is 40 years.) Given the many improvements in the institutional and policy frameworks that this would require, growth returns during such convergence and directly following reform implementation, would also be significant. Compared to the average 1.2 percent annual growth of the past decade, improving on these measures could add up to around 7 percent a year growth rate during the 20 years it takes to converge, according to a simulation (Box 2).

Figure 2. Narrowing the gap with Germany through structural reforms can bring large growth dividends for Serbia.

Source: Rovo (2019) “Structural Reforms to Set the Growth Ambition”, background paper for this report. Notes: see Box 2 for more detailed explanations of the variables.
Box 2. Details on the simulations to set the growth ambition

Structural reforms are the only way to boost economic potential. But how much in terms of additional GDP growth could each reform bring, and which reforms are the most important in this regard? To answer this question, we conducted a hypothetical simulation of Serbia achieving the level of Germany on in several indicators that reflect the outcomes of structural reforms implementation.

Assuming a Cobb-Douglas production function, we decompose GDP growth into a sum of separable and independent components: capital, labor, and productivity. While factors of production can be estimated from data, productivity and its determinants are estimated through the stochastic frontier analysis, which allows to compute, for a given sample of countries, the maximum amount of output given the factors of production and technology available.

Using cross-country panel data regressions, and a number of robustness checks on the full sample of advanced and emerging markets, the analysis identifies the key structural determinants of growth, and the channels they work through, from a large set of structural and macroeconomic indicators. These indicators were selected in line with the 12-pillar competitiveness framework developed by the World Economic Forum. While being widely used, the methodology has some limitations, including the potential endogeneity and collinearity of the regressors. The study tries to address to the extent possible these issues and provides evidence for the robustness of the results.

Our analysis shows that improvements in regulatory quality and government effectiveness have the most impact on potential growth, along with human capital quality and financial development. Improving access to finance for private sector may boost growth by favoring investment in physical capital, while enhancing the quality of education and skills has an impact on economic growth mainly by favoring employment and boosting productivity. EU accession may also be positively associated with growth, mainly by encouraging capital deepening.
Using estimates from the empirical model, we simulate the impact of structural reforms on economic growth. Rather than a precise estimate, the simulations aim at quantifying the relative importance of each reform area. After assuming the speed of convergence to the frontier for each indicator, the corresponding increase in GDP is calculated through combining the estimated increases through the three channels described above. Since this methodology does not account for policy sequencing or specific program design, the resulting growth rate is obtained by distributing growth equally across the years of convergence to frontier on the indicators. As such, this simulation therefore does not predict future growth, but serves as an approximation of the growth rate assuming the most effective policy program is chosen with impact averaged by years of convergence.

In Figure 2, variables are defined as follows. Financial development is measured by credit to the private sector as a percentage of GDP (WDI). Regulatory quality indicator reflects perceptions of the ability of the government to formulate and implement sound policies and regulations for private sector development (WB-WGI). Government effectiveness indicator reflects perceptions of the quality of public services, the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government’s commitment (WB-WGI). Availability of latest technology indicator captures the perception of survey respondents of the extent to which latest technology are available in the country (WEF). Quality of human capital is approximated as the average years at school weighted by an assumed rate of return to education (Penn World tables). The working time regulation index measures the extent of regulation of working time (Cambridge CBR). The trade-weighted average applied tariff rate is from the WEF. Finally, the variables on the left of the y axis indicate areas where Serbia has passed the frontier: the number of hours to start a business (according to the Doing Business); top marginal income and payroll tax rate (according to Fraser). Variables not included because of relatively small effects are energy use per capita (WDI) and Internet use (WEF); the EU accession dummy is also not included.

Source: Rovo (2019) Structural reforms to set the growth ambition, background paper for this report.
Is it realistic? As the indicators in Figure 2 demonstrate, measured by tax rates, or the cost of starting a business, Serbia already does better than Germany. Other areas stand out as opportunities to unlock stronger growth: making government more effective; enhancing the skills of the labor force; deepening financial sector development; improving regulatory quality. Relatively smaller benefits will accrue from further improvements to labor market regulation, increasing availability of the latest technologies, and further reducing tariffs. There is no doubt that a growth strategy which achieves progress and convergence with Germany on all these indicators simultaneously in 20 years’ time would be extremely ambitious. As experience in Korea or EU accession countries such as Poland shows, such ambition or success are not unprecedented, however. This would require deliberate effort, careful planning and sequencing of reforms, and alleviation of any political constraints to these reforms. Growth benefits may also not be spread evenly across the convergence horizon, as they will follow specific reforms; if convergence takes longer than 20 years, growth rate would also be lower (Box 2).
If Serbia can engineer changes to improve on each of these indicators, each of the components of growth (labor, capital, and productivity) would contribute more to expanding the economy. The structure of the report builds on a simple production-function-based analytical framework (Table 1). Output is the outcome of three factors that interact with one another: capital, labor, and productivity. Macroeconomic sustainability is a precondition for growth since it reduces uncertainty for consumers and investors. Capital represents the physical means of production, such as infrastructure and equipment. Capital needs to be maintained and expanded through investments. Capital also needs to be financed by a vibrant and stable financial sector or by foreign investors. Labor and human capital represent workers who use physical capital to produce output. More workers with higher skills lead to higher economic growth. Productivity and enterprise performance capture policies to make firms more productive in using capital and labor, and to grow. Assuming this form of the production function, a one percent increase in productivity would result in a one percent increase in growth. Finally, governance and well-functioning institutions—for example, the regulatory framework, public sector efficiency, state presence in the economy, and service delivery—are important to raising capital, labor, and productivity.

Given that employment growth has started to bring significant growth benefits recently, key drivers of future growth would be investment, productivity, and human capital (Figure 3).

figure 3. Increase in each component has the potential to bring more growth. (contributions to growth, percent)

Advances in upgrading human capital, an effective regulatory regime, enough financial instruments for firms to draw on, or availability of the latest technologies, would open the way for productivity to become the main driver of Serbian growth. If firms could do more with the same workers and machinery, they could generate more output with the same inputs. The higher the speed at which this efficiency increases, the higher GDP growth (all else being equal), and the faster wages rise without stoking inflation. More investment would flow, because returns to capital will rise. Tax revenue would also rise. A virtuous circle would ensue.
The current level of investment in Serbia is insufficient to sustain high long-term growth. For the past five years, total investment in Serbia has averaged 18.8 percent of GDP, only recently increasing to 22.7 percent of GDP in 2018 (Figure 4) and projected to reach 23.3 percent in 2019. This falls short of the 25 percent recommended for sustainable long-term growth. Simulations for Serbia’s long-term GDP growth to reach 7 percent annually assume that total investment is at least 26 percent of GDP and is sustained on that level for a long period of time.

Serbia’s public investment is a third less than that in CEE countries, and the composition of public spending has not been geared for faster growth. At about 3 percent of GDP, public investment is about 1.3 percentage points below the average in CEE. Had the Serbian government been investing as much as these other countries since the start of transition, its GDP would have been about 25 percent higher than it currently is. And the composition of public spending is not growth-enhancing. Even after the recent consolidation, Serbia still spends 5–6 percent of its total budgetary resources on subsidies (2.2 percent of GDP), mostly to loss-making state-owned companies (Figure 5). Moreover, general government, including large SOEs, borrow domestically and account for 42 percent of new loans from domestic banks, constraining the credit available to the private sector. Difficulties in accessing credit reduce investment by firms and their productivity; SOEs are also on average significantly less productive, compared to similar companies in the same sector.

Reducing inefficient legacy spending while increasing public investment would have an immediate positive impact on GDP growth. Recent fiscal consolidation presents a great opportunity to make public spending more growth-friendly, while maintaining low fiscal deficits, by keeping recurrent spending under control while reducing state aid to the levels typical for the EU. The nature of public investment and how it is implemented also matters for the future. The focus of government capital expenditures should be on infrastructure that helps the private sector to grow and connect to markets, including in education, transport, energy, water, and environment. To ensure that the impact of public investment on growth is significant, and resources are not wasted, ongoing public investment management reforms need to stay on track: reduce investment program fragmentation, introduce strategic vision, and install a clear delineation of responsibilities in projects design, selection, financing, implementation, supervision and evaluation.

If Serbia increased public investment to equal those in other Eastern European economies since 2001, its growth would have been more than 1 percentage point faster and the economy a quarter larger.

Figure 4. Investment has been chronically low.
(Serbia compared to neighboring and CEE countries, percent, 2010-2018)

Private, not public, investment drives growth in most countries. In recent years, net FDI averaged 5.5 percent of GDP, which puts Serbia on the third position in the Western Balkans. Yet, Serbian firms invest much less than their counterparts in other transition economies. Private sector investment over the past decade has been 17 percent of GDP, a gap of nearly 3 percent of GDP with other Western Balkan countries and almost 6 percent less than CEE countries (Figure 6). At the same time, there have been changes in the composition of investment as companies are increasingly investing in buildings and business premises, and less in machines and equipment. There has also been a shift in composition from manufacturing to non-tradeable sectors, which is not supportive to otherwise needed further expansion of exports.

Investment is the key to hiring, innovation and increased productivity, and the rules around private-sector decisions are key to investment. Public access all administrative requests and procedures would improve transparency for start-ups and SMEs. And although Serbia has overtaken
many developed countries on the ease of doing business, unfinished legislative reforms would help. This can be helped by small but important steps: establishment of the public register of para-fiscal charges to eliminate double charges, and those by municipal utilities; another update to the labor legislation, to accommodate “mini” and part time jobs; and final clarity on lingering property ownership issues.⁵

Private investment is the main driver of growth in most countries. Yet, Serbia’s private sector invests 5.9 percent of GDP less a year than countries in CEE.

⁵ See section below on Improving the Business Environment for more elaborate suggestions.
Firms that borrow tend to be more productive, but smaller, younger ones find Serbia’s bank-dominated financial sector challenging. Because firms use external financing for investments and expansion, firms that borrow also tend to be more productive (Figure 7). But banks have tight lending standards, require good collateral, a solid track record of several years, and good financial accounts. All these can be challenging for new or young firms (Figure 8). These kinds of firms are crucial drivers of job creation and constitute the new generation of firms that may drive productivity growth in the future.

Small firms, start-ups, and innovators need access to a wider array of instruments and providers to continue their growth trajectory. Start-ups and small firms can benefit from better access to venture capital and micro loans, instruments that are aimed at supporting firms that have just started and tend to be too risky for banks to finance. For micro loans, a supportive legal and regulatory framework would help spur their growth. FinTech innovations such as crowdfunding and person-to-person lending could also make an impact in Serbia. In this respect, transposing the EU Payment Services Directive 2 would help as would a regulatory framework for crowdfunding. Smaller firms can benefit from leasing assets rather than purchasing them. Selling invoices at a discount (factoring) can also help meet their immediate cash needs.

Firms that access credit are more productive than those that do not.

Private sector credit in Serbia is 44 percent of GDP compared to 80 percent in the EU.
needs. Updating legal frameworks for leasing and factoring, making e-signatures legally binding, and eliminating the adverse tax treatment of leasing would help. Based on a comparison to the EU, the leasing sector, for example, could contribute an equivalent of about 0.5 percent of GDP to SME financing, while factoring could contribute up to 5 percent.

**Capital markets are not doing what they could for financing needs.** In 2018, Serbia saw its first IPO since 1940. Serbia’s stock and securities markets trail its peers by a large margin. There have been very few corporate bond issuances and initial public offerings, partly because large firms can get bank loans at affordable interest rates. To reignite capital market development, Serbia needs better functioning government bond and money markets, and a strategy for increasing the institutional investor base and encouraging companies to use capital markets.6

---

If Serbia doubled its private sector credit relative to GDP to 80 percent, annual real GDP growth could increase by about 1.3 percentage points. Private-sector credit to GDP, a common indicator used to measure financial intermediation, is only about half of the EU average (44 versus 80 percent), an indication that the financial sector is not doing what it can to support growth. The financial sector has staged an impressive recovery from the crisis, with capital and liquidity in line with EU levels and a large drop in non-performing loans. Progress has also been made in reforming state-owned financial institutions with the strengthening of Banka Postanska Stedionica and the successful privatization of Jumres Banka, however more remains to be done, including completing the privatization of Komercijalna Banka.

In countries with a well-developed microfinance industry, small firms can get loans without collateral or credit history.

Introduction of operational leasing can add about 0.5 percent of GDP, or USD 250 million, in additional financing for SMEs.

If factoring was on par with the EU, it could add about 5 percent of GDP, or USD 2.5 billion, in additional financing for SMEs.

7 Based on model simulations, see Figure 2 and Box 2.
Thanks to previous reforms, Serbia’s recent growth has come with job creation, and a concomitant increase in employment. Serbia created about 60,000 jobs a year, reducing unemployment\(^8\) from almost 20 percent in 2014 to just above 13 percent in 2018, among the two lowest in the Western Balkans. The formal private sector drove most of the job creation while the share of informal employment declined slightly (Figure 9). Net job creation was considerable in industry, and especially in services, reflective also of the structural transformation away from agriculture (Figure 10). Recent labor market improvements have also benefited vulnerable groups like women, older workers, and youth.

One in three people is without a job but not actively searching for work.

The formal private sector employs only 30 percent of people aged 15–64.

The economy could grow faster if more people enter the labor force and stay in it, in productive jobs. And yet, in Serbia more than a third of working age population is not participating in the labor force. Less than 60 percent of those aged 15–64 are employed, 10 percentage points lower than the EU

---

\(^8\) Among those aged 15-64.
average.\textsuperscript{9} Not working means that on average, a male worker in Serbia loses about 20 years of his potential productive lifetime (25 years for females).\textsuperscript{10} If females could simply work as much as males do, income per capita could increase by 16.2 percent.\textsuperscript{11} If the 50 percent employment gap, as well as the gap in earnings, between the country’s Roma minority and the general population in Serbia were closed, the total gains could be from 0.9 to 3.5 percent of GDP.\textsuperscript{12} The available labor force itself is shrinking due to ageing, a low fertility rate, and outmigration. The number of people aged 15–64 fell by 5 percent between 2014–18, making the remaining workers even more precious, and improving their productivity a greater imperative.

\begin{itemize}
  \item \textsuperscript{9} Serbia LFS, Eurostat, World Development Indicators.
  \item \textsuperscript{10} Following method in Arias et al. Europe and Central Asia: Back to Work.
\end{itemize}
Although the formal private sector drove employment growth, it only employs less than one-third of Serbians aged 15–64. Informal employment represents about 20 percent of Serbia’s total employment (Figure 11). More than 20 percent of youth (aged 15–24) were not in employment, education, or training, a high ratio by international standards. Too many people in Serbia are not working or looking for jobs. One in three people is not even actively searching for work. And when they do look for a job, roughly 75-85 percent take more than a year to find one.

In almost all occupations, more than 60 percent of hiring firms have problems finding workers.

Firms would create more jobs if they can more easily find workers with the skills they need. In 2014, about 15 percent of all companies indicated problems with finding new workers, mainly due
Figure 12. Most firms experience difficulties in hiring workers.
(percent of hiring firms experiencing problems)

<table>
<thead>
<tr>
<th>Occupation</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elementary</td>
<td>43</td>
</tr>
<tr>
<td>Managers</td>
<td>60</td>
</tr>
<tr>
<td>Drivers, operators, assemblers</td>
<td>61</td>
</tr>
<tr>
<td>Service workers</td>
<td>63</td>
</tr>
<tr>
<td>Clerical support</td>
<td>71</td>
</tr>
<tr>
<td>Technicians, assoc. professionals</td>
<td>74</td>
</tr>
<tr>
<td>Construction, craft</td>
<td>77</td>
</tr>
<tr>
<td>Sales workers</td>
<td>78</td>
</tr>
<tr>
<td>Professionals</td>
<td>79</td>
</tr>
<tr>
<td>Skilled agriculture</td>
<td>87</td>
</tr>
</tbody>
</table>

Source: Serbia STEP report, Estimates based on STEP Employer Survey.

Figure 13. Education system does not produce workers with adequate skills: one-third of students are functionally illiterate.
(percent of 15 year-olds scoring “below level 2” on PISA reading test)

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>78.7</td>
</tr>
<tr>
<td>Poland</td>
<td>55.1</td>
</tr>
<tr>
<td>Slovenia</td>
<td>52.2</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>44.4</td>
</tr>
<tr>
<td>EU Average</td>
<td>37.7</td>
</tr>
<tr>
<td>Croatia</td>
<td>37.7</td>
</tr>
<tr>
<td>Russia</td>
<td>37.7</td>
</tr>
<tr>
<td>Latvia</td>
<td>37.7</td>
</tr>
<tr>
<td>Lithuania</td>
<td>37.7</td>
</tr>
<tr>
<td>Hungary</td>
<td>37.7</td>
</tr>
<tr>
<td>Turkey</td>
<td>37.7</td>
</tr>
<tr>
<td>Greece</td>
<td>37.7</td>
</tr>
<tr>
<td>Slovak Rep.</td>
<td>52.2</td>
</tr>
<tr>
<td>Serbia</td>
<td>52.2</td>
</tr>
<tr>
<td>Romania</td>
<td>52.2</td>
</tr>
<tr>
<td>Moldova</td>
<td>52.2</td>
</tr>
<tr>
<td>Cyprus</td>
<td>52.2</td>
</tr>
<tr>
<td>Montenegro</td>
<td>52.2</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>52.2</td>
</tr>
<tr>
<td>Albania</td>
<td>52.2</td>
</tr>
<tr>
<td>North Macedonia</td>
<td>52.2</td>
</tr>
<tr>
<td>Georgia</td>
<td>52.2</td>
</tr>
<tr>
<td>Kosovo</td>
<td>78.7</td>
</tr>
</tbody>
</table>


Among the firms that were actively hiring, most had difficulty in finding the workers they needed (Figure 12). The results held across skilled and unskilled occupations but were more severe in the higher skill segment.\(^{13}\) Across different data sources, lack of required skills and work experience was the main reason for difficulty in filling vacancies. In the low-skilled segment, on the other hand, high social security contributions together with personal income tax (amounting to 38 percent of the take-home pay for those workers earning two-thirds of the average wage) make hiring expensive and encourage off-the-books employment.

To increase job creation, better matching of employees to firms, reduced costs in the lower skill segment, and workers with better skills would

---

\(^{13}\) According to National Employment Services (NES) employer survey data.

\(^{14}\) 2015–16 STEP Employer survey.
help. Serbia already undertook significant reforms of its labor regulations in 2014-2015, resulting in a more flexible labor market. Further reforms in the labor market could bring an additional 0.1 percent in growth. In particular, a more progressive income tax, tax-exempt brackets for workers with children, and subsidies of social security contributions for low-income workers would make labor markets more inclusive and encourage low-wage earners to move into the formal sector. Serbia can also strengthen job matching by enhancing monitoring and evaluation and flexibility of active labor market policies. Better skilled workers will be more productive, and if the education system produced workers more fit for the demand of the modern labor market, growth would also increase.

The educational system does not currently turn out workers with skills that are in demand by growing firms. Although Serbia has a well-developed education system with high enrollment rates, functional illiteracy and innumeracy remains high, with one-third of students that are functionally illiterate or lack the basic proficiency in reading (Figure 13). Diplomas do not necessarily equate to the skills currently in demand; the 22 percent of unemployed Serbians who have tertiary education still cannot find a job. In line with global trends, job profiles in Serbia are increasingly shifting from manual to cognitive tasks. Employers today value a broad combination of skills. In addition to the cognitive skills (like problem-solving and critical thinking) and job-specific technical skills typically taught in traditional education and vocational training, employers often emphasize the need for stronger socioemotional skills (like teamwork, self-control, reliability, stress resistance, and resilience).

To produce such skills, a reform of the education and training system is required. To create a good foundation for future learning, early childhood education enrollment rates will need to increase. Modernizing the curriculum and increasing efficiency of the school system will help deliver quality learning and the combination of skills that today’s economy demands. Serbia has one of the highest shares of students streamed into vocational education and training (74 percent), with high cost and significant mismatch between students demand for these programs and the supply of spaces. There is a continuing need to assess the market relevance of training profiles and update them. Accountability, quality assurance in higher education, and its connection with labor demand all need improvement.

---

15 The reform made labor regulations more flexible in many areas, including for example contracts, working arrangements, and employment termination. As a result, Serbia’s employment protection legislation (EPL index) is generally in line with OECD countries.

16 For example, one area where the available workforce skills provide opportunities for the private sector is the ICT sector. Serbia ranks among the top 5 countries worldwide in ICT talent on the Startup Genome list.
Productivity could become the main driver of growth in Serbia. Because productivity is the efficiency with which firms use their employees and the capital at their disposal, productivity-enhancing policies would boost economic growth, even if capital and labor would remain the same. Productivity can increase if firms introduce better production processes, use more modern technology, and upgrade skills of workers. In addition, aggregate productivity can increase through allocating capital and labor to more productive firms.

A Serbian manufacturing firm needs three times as many workers to produce the same level of output as an EU firm. These differences are even larger for small Serbian firms with fewer than 10 workers, who are five times less productive than those in the EU (Figure 14). Services firms, especially those in ICT, are performing slightly better, even though their productivity is still only half that of the EU firms.

Yet, in Serbia, more productive firms employ more people, pay higher wages and are more likely to export than less productive firms. A firm in the top 20 percent of the most productive firms pays triple the wage of a firm in the bottom

The most productive 20 percent of firms pay 3 times higher wages than the least productive firms.

17 The analysis in this report and Davies (2019) “Boosting Productivity for Faster Growth” (background paper for this report) relies on two measures of productivity: (1) value added per worker (labor productivity), representing the efficiency in using labor to produce and (2) total factor productivity (TFP) which corrects for both capital and labor use.
Moreover, exports are closely related to productivity. The median exporting firm has twice the amount of value added per worker than the median non-exporting firm, and total factor productivity is 30 percent higher. Similarly, the top 20 percent most productive firms account for 56 percent of exports, while the bottom 20 percent least productive firms only account for 0.4 percent of exports. This is because exporting firms have to become more efficient as they operate in the highly competitive international environment; at the same time, learning through exposure to best practices can further increase productivity.

Productivity in Serbia grows by only 1 percent a year. Poland achieved 20 percent a year productivity growth between 1997 and 2000.

20 percent.\textsuperscript{18} Moreover, exports are closely related to productivity. The median exporting firm has twice the amount of value added per worker than

\begin{itemize}
  \item Measured by the total factor productivity.
  \item Several studies have provided evidence that firms starting with exporting increased their productivity (learning by exporting), e.g. De Loecker (2013) “Detecting learning by exporting”, American Economic Journal: Microeconomics, 5 (3), or Keller (2010), “International Trade, Foreign Direct Investment, and Technology Spillovers.” Handbook of the Economics of Innovation, Vol. 2.
\end{itemize}
Productivity growth therefore has already created more jobs, higher value-added production and exports, and higher wages. In Serbia productive firms also employ more people and are those who created the majority of new jobs. However, productivity has only been growing slowly: by one percent a year. Between 2012 and 2017, total factor productivity grew by 0.94 percent, very low for its peer group. For example, Poland between 1997 and 2000 achieved 20 percent total factor productivity growth in the manufacturing sector, thanks to major reforms leading up to EU accession. In Serbia, most of productivity growth has come from manufacturing and construction, while other sectors stagnated or declined in productivity, like wholesaling, hospitality and professional and technical services sectors.

State-owned enterprises drag down productive growth in sectors with potential. Reforms of SOEs and privatization have led to a reduction in employment and increase of productivity of state-owned enterprises and privatized firms (Figure 15). Nevertheless, SOEs remain about a quarter less productive than other firms in their sectors, and they are more prevalent in Serbia than in similar countries. For example, SOEs account for 28 percent of employment in fabricated metal products, 12 percent in construction, and 9 percent in furniture production. The presence of state-owned enterprises can distort prices along the value chain, introduce discretion into the market mechanism, and distort the playing field.

A state-owned manufacturing firm is a quarter less productive than an average private firm in its sector.

The private sector, especially domestic firms, has driven productivity and employment growth. Domestic firms created since the post-1990 transition have been the key employers in the economy and have recently started to increase their productivity and employment (Figure 15). They now provide 53 percent of jobs in the formal private sector, and created 66,000 new jobs between 2014 and 2017, nearly 60 percent of net job creation. These firms form the backbone of the Serbian economy and have been the main source of productivity growth. Cultivating a business environment for these firms to thrive and continue to expand and become more

---

20 Productivity increases do not necessarily go hand-in-hand with employment increases: for example, Serbian SOEs increased productivity while reducing employment (not taking into account leasing of employees through professional employment organizations). On aggregate, in Serbia, there is a positive relationship between total factor productivity and employment, and total factor productivity and job creation. Between 2014 and 2017, the top 40 percent of manufacturing firms by productivity created twice as many more jobs as the rest of the firms.

21 Only privatized firms in foreign ownership saw a recent increase in employment. A similar growth of total factor productivity, including of SOEs and privatized firms, is observed in regressions that control for the sectoral composition and business cycle.
High growth firms: only 5 percent of firms created 77 percent of net new employment. Compare to Latvia, where 45 percent of firms are high-growth.

Productive is crucial for further economic growth. FDI firms have similarly created jobs, but many of these new jobs were in less productive and lower value-added firms, leading to a decrease in average productivity of these firms as a group (see Box 7 for a discussion).

But of late, only a small group of firms drove employment growth. Only five percent of firms — so-called high-growth firms, that increased their revenue by more than 20 percent annually over three years — contributed to 77 percent of net job creation between 2014 and 2017 (Figure 16). Yet, there are not enough high growth firms. In other countries, high growth firms make up to 45 percent (Latvia) of firms. In addition, young firms created 96 percent of net new jobs between 2014 and 2017. Outside of young firms and high-growth firms, employment decreased by 65 percent, making these categories of firms the main driver of job creation.

**Figure 15.** New domestic private firms have been the main driver of employment and productivity.

(Value added per worker in the manufacturing sector, vs employment)


In this report, we define young firms as those that are less than five years old.
One percent productivity growth is not enough to achieve 7 percent GDP growth. Serbia should aim for at least a doubling of its productivity growth. Up until 2014 most of productivity gains were achieved through a better allocation of labor and capital to more productive firms, allowing them to grow (Figure 17). However, this pattern reversed between 2014 and 2017, as economic transformation gave way to workaday market functioning. In the case of services, more productive firms grew more slowly than less productive ones. More productivity growth could also come from enhancing firm capabilities to produce more efficiently, such as fostering higher investment in research and development by firms.

---

Removing constraints to doing business, entry and competition should help increase the number of high growth firms. In the same way, policies that encourage competition, level the playing field and equalize access to finance, as well as improve skills, would allow for more labor and capital to flow to the most productive firms, increasing overall productivity in the Serbian economy. In addition, an innovation policy that improves collaboration between firms, academia, and funding institutions, could promote emergence of innovative start-ups and encourage more investment in research and development. Removing constraints to trade, so that more firms import, export, and join the global value chains (GVCs) would also help raise productivity, given that exporting firms are more productive than non-exporters.
A key potential source for growth lies outside Serbian borders. Serbia’s exports of goods and services grew from 30 percent of GDP in 2006 to 51 percent of GDP in 2018. Serbia has doubled its import share in the EU market since 2007. The country is also exporting more products, especially from the automotive industry. 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 between 2007 and 2018. Increasing exports to 80 percent of GDP, like in other small transition economies of Europe, would be an incredible source of growth.

Despite these successes, Serbia introduced only 47 new export goods between 2008 and 2017, and the complexity of its exports did not increase. During the same time, 201 new export products emerged in Croatia and 312 in Lithuania. A very small number of products created in Serbia during this time embed high-level of skills and technology content in their production. At the same time, the complexity of the overall basket of products that Serbia exports has been falling, in favor of raw materials and lower value-added

In Serbia, a firm that exports is twice as productive as a firm that does not, due to tougher competition abroad and more opportunities to learn.
products, like insulated wire, steel, copper, maize, wheat, tobacco, apples and frozen raspberries (Box 3). Low complexity and sophistication of exports, and slow improvements in this area, reduce Serbia’s ability to compete internationally and signal limited prospects for future increases in exports.

Half of Serbian exports originate from foreign-owned firms, which source little domestically. Gains in manufacturing exports have been driven by a few large foreign exporters. Higher exporter concentration in vehicles, electronic equipment, as well as rubber and plastics and fabricated metals are behind this trend. The FCA Srbija (FIAT) plant, a centerpiece of FDI, was not the main catalyzer for the development of a thriving auto vehicle parts industry, as it imports most of its parts from abroad. Even though, between 2006 and 2018, Serbia managed to increase the amount of processing trade from 6 percent to almost 30 percent of all final goods exported, FDI firms do little local sourcing. Domestic inputs (with the exception of labor and

Box 3. Raspberries, a successful export, but with low complexity and value added.

Raspberries comprised more than two thirds of Serbia’s fruit and vegetable exports in 2015 and generated over €250 million in revenue, benefiting more than 80,000 farms. Serbia is one of the global leaders in the production of frozen raspberries, accounting for approximately 18 percent of world exports. The main export markets are wealthy countries in Europe and North America.

Almost all raspberries are exported frozen and thus ember little value added compared to e.g. exporting fresh ready to consume raspberries, but opportunities abound to change that equation. These possibilities include moving production towards retail-ready packaging with new processing technologies, such as freeze-drying; producing and distributing more fresh raspberries; through thermal processing, with organic certifications; introducing new varieties that are more suitable for direct consumption; investing in supply chain facilities: cold storage facilities, irrigation systems and other technologies to prolong the seasonal availability, and improved yields and quality; and expanding exports of jams, juices, concentrates, purees, or other culinary supplements or raspberry products.

Export-promotion activities such as the dissemination of market information among exporters, promotion of new production techniques for fresh berries and thermal processing and building of branding of final products would help farmers to scale up in this segment.

energy) are estimated at 9 percent of all projected input costs in 2019. Almost 30 percent of the increase in exports involves imports of goods for processing in Serbia, with products then being exported back to the country of origin. These create few possibilities for spillovers and participation in the global value chains for local companies.

Removing constraints to GVC participation can boost growth. Large growth spurts can occur when countries transition from exporting commodities to exporting basic manufactured products or join value chains. A 1 percent increase in GVC participation can boost a country’s per capita income by more than 1 percent, or by more than the 0.2 percent income gain from the standard trade liberalization that Serbia has already experienced. However, these high growth rates cannot be sustained without moving to progressively more sophisticated forms of GVC participation. Participation in advanced and innovative manufacturing and services supply networks could be encouraged by several policy changes.

Further improvements in trade facilitation will help raise exports. Serbia reduced tariffs and non-tariff barriers such as import quotas, licensing requirements, and prohibitions to join the WTO. Additional trade facilitation measures, such as the harmonization of regulations and procedures; the National Single Window, a single point of government contact for importers; digitization of border queuing management and transport management systems would complement this change. Further decrease in tariffs, such as those affecting raw materials, could add 0.1 percent to the annual growth. But elimination of behind-the-border constraints such as weak ICT infrastructure, quality and trade-enabling services of river ports, rail and road systems, transport, warehousing and brokerage services, weak courts and legal services, and foreign exchange controls, would bring much higher benefits.

Domestic export policies need to be as enabling as possible to ensure survival of the exporting firms and facilitating GVC participation. The best policies seek to maximize exporters’ ability to produce and to minimize unnecessary or unintended regulatory hurdles. As well, Serbia is competing with other countries as a host country for export-oriented FDI, reinforcing the need to upgrade ICT infrastructure, enabling and professional services, and build the base and the quality of suppliers.

Attorney, court, and enforcement fees are around 13 percent of the costs of claims, the highest registered among the Western Balkans and 7STEEs peers.

Excessive or inefficient regulatory barriers and complicated procedures can limit new firm entry, investment, and job creation. In turn, this negatively affects productivity and competitiveness of firms. Such barriers can include high regulatory and administrative costs, as well as discretion in the implementation of business regulations. They can distort the playing field by giving unfair advantages to specific firms or creating an uncertain business environment. A regulatory environment that is most conducive to growth would be more streamlined, transparent and consistent, with an even playing field for all firms.

Serbia has been successful in reducing the time and cost of doing business. Given that excessive or inefficient regulatory barriers and complicated procedures can limit new firm entry, growth, innovation, and job creation, this is no small success. Serbia ranks 44th globally in the World Bank’s Doing Business 2020 report, up from 93rd in 2013. Over the last six years, Serbia closed most of the gap with the other 7STEEs (Figure 18). An example of Serbia’s remarkable ability to reform is the streamlining of construction permitting. In five years, Serbia moved from the bottom five countries to the top ten globally by halving the time and reducing its cost by over 90 percent.

Serbia dramatically improved its Doing Business rating over the last five years. Yet it is lagging its peers on competition.
However, Serbia has not addressed deep-seated structural and institutional issues with its business environment. For example, Serbia performs poorly on voice and accountability, rule of law and control of corruption. On all these indicators, Serbia ranks significantly lower than the 7STEEs, and in fact on voice and accountability and control of corruption, Serbia has been backtracking over the last five years (Figure 19 and Box 4). Related to this, it performs less well than on other Doing Business scores such as on Enforcing Contracts, with a distance-to-frontier score of 63.1. Other areas that are lagging are registering property rights and simplifying/digitalizing government services. In all these areas, faster progress on EU accession would help Serbia upgrade its legislation and institutional environment, automatically helping businesses.


Notes: 7STEEs – seven small transition economies of Europe: Bulgaria, Croatia, Estonia, Latvia, Lithuania, Slovak Republic, and Slovenia.

Source: World Governance Indicators.
Box 4. Critical importance of governance and accountability for the New Growth Agenda

Governance and institutional weaknesses are key constraints on Serbia’s growth. Although selected governance reforms have taken place since 2015, some areas have seen stagnation or reversals. To achieve higher growth and incomes envisioned by the New Growth Agenda, Serbia will need concerted efforts to strengthen governance and accountability.

**Government effectiveness:** Serbia has strengthened policy making, coordination, and effectiveness through the 2018 *Law on National Planning* and by other laws and amendments related to public sector performance. However, overall government effectiveness has recently been stagnating rather than improving. Serbia’s World Governance Indicators (WGI) government effectiveness score dropped from 58.2 in 2014 to 56.7 for 2018, on a scale of 0 (worst) to 100 (best), compared to an average score for the 7STEEs of 76.6 in 2018. While austerity-related caps to public sector employment have played a role, other practices such as uncompetitive selection of managerial and other staff and over-reliance on acting public sector managers for extended periods also limit effectiveness. Such practices affect the level of professional expertise retained and the independence and initiative in decision-making.

**Transparency and Accountability:** Serbia currently ranks behind the 7STEEs and EU comparators on the transparency of its policy making and budgets. The Open Budget Index rated Serbia at 43 in 2017 compared to an average of 63 for the 7STEEs, on a scale of 1 (worst) to 100 (most transparent). With better knowledge of government policy priorities and spending, citizens can hold it accountable so that public services and investments best serve their needs. Internally, government can strengthen incentives for transparency and accountability (results) in public resource allocation such as state aid or agricultural land and therefore ensuring allocation to most productive aims.

**Control of Corruption:** National surveys as well as global indices show recent drops in indicators of perceptions of corruption in Serbia. WGI scores on control of corruption decreased from 52.4 in 2015 to 49.0 for 2018, on a scale from 1 (worst) to 100 (best), while the Balkan Barometer (2019) shows that 49 percent of respondents strongly believe that there is political interference in the judiciary – the highest across the Western Balkans. Real or perceived corruption undermines confidence in the rule of law, distorts the business environment, and holds back investments. Serbia recently amended two laws relevant to control of corruption, a positive step in this effort. To succeed, Serbia will have to energize implementation of anti-corruption laws and strengthen the Anti-Corruption Agency.
Box 4. cont.

Transforming governance towards greater accountability and effectiveness is challenging but possible. Georgia achieved rapid gains in government effectiveness and in reducing corruption through extensive transparency and control measures in the mid-2000s and, despite challenges, has maintained improved levels. Its economy rebounded more strongly from the post-2008 recession than Serbia’s (GDP per capita grew by 5.1 percent on average during 2010-2018.) For Serbia to fully benefit from the New Growth Agenda action is necessary to improve government effectiveness, institutional transparency and accountability, and deal decisively with real or perceived corruption.

Sources: https://www.rcc.int/pubs/89/balkan-barometer-2019-public-opinion-survey
https://www.internationalbudget.org/open-budget-survey/open-budget-index-rankings/

There are opportunities for improvement through all the stages of regulatory processes. Businesses and international partners most often cite issues with predictability, as well as consistency of implementation. Strengthening public consultation processes could help address issues with predictability. Laws are often adopted using expedited procedures, without proper public consultations. Also, regulatory impact assessment mechanisms exist, however their actual use in informing legislative changes is limited and their quality could be improved, including with regards to how it will impact SMEs. Some of these weaknesses have been recognized and the recently adopted Law on Planning System is aiming to introduce much more robust and clearer procedures of adopting and amending legislation. In addition, establishment of the public register of

29 For example, the EU Progress Report from March 2019 in the section on Economic Governance notes: “The efficiency and predictability of the institutional environment is not yet ensured and does not sufficiently support long-term growth.” FIC White Book for 2018 notes as one of the six priority areas in the previous year: “Improvement and a more consistent implementation of tax laws, including prevention of new para-fiscal charges.”
30 The EU Progress Report from March 2019, section on Functioning of product markets: “Business-related laws continue to be adopted under urgent procedure without the necessary consultation of interested groups, reducing predictability and quality of legislation.”
31 An analysis from January 2018, financed by UKAID, showed that in 2014-2016 public consultations process was implemented for less than 50 percent of adopted laws.
32 The EU Progress Report from 2019 notes: “The regulatory impact assessment and the SME test need to be systematically performed when formulating laws and secondary legislation. In general, businesses need to be better informed about regulatory changes and be actively invited to provide input in the process leading up to this regulation.”
para-fiscal charges to eliminate double charges, and those by municipal utilities; another update to the labor legislation, to accommodate “mini” and part time jobs; and final clarity on lingering property ownership issues, would also help.

Wider use of digital and e-governance platforms could help when it comes to consistency of implementation. The latest Doing Business report notes that the economies that score the highest have different characteristics, but all feature widespread use of electronic systems and online platforms to comply with regulatory requirements. The Serbian government is making important steps in this regard, including through the e-Paper initiative. About 2,500 different administrative procedures have been identified, and 1,750 will be simplified, with a subset of these being digitized and moved on-line.

Some issues of existing law, both implementation and form, remain. For example, important amendments to the Law on Legalization of Properties were adopted in 2018. However, its implementation is hampered by a large backlog of over 1.5 million structures. Among other things, this prevents expansion of these assets (e.g. industrial plants and infrastructure). Similarly, Law on Land Conversion (from land use to land ownership rights) was adopted in 2016. Yet for most of the companies bought through privatization or bankruptcy, conversion is moving slowly. This delay prevents the productive use of significant assets. The Foreign Exchange Law, a complex provision with 33 by-laws, requires significant streamlining, which would make it easier to do business for MSMEs, as well as encourage investment in Serbia and from Serbia to other countries.33

Curbing state barriers to business lets firms operate more freely, but it doesn’t make them compete. Pro-competition reforms are complementary to reforms that cut red tape (Figure 20). They share the objective of reducing barriers to entry and other regulatory burdens. At the same time, pro-competition reforms address also other types of government interventions, such as state aid or access to essential infrastructure, as well as privately imposed barriers to competition. Pro-competition reforms tackle problems of an unlevel playing field between firms and the distortion of markets.

Best performing economies in the Doing Business rankings have different characteristics, but all feature widespread use of electronic systems and online platforms to comply with regulatory requirements.
Figure 20. Despite progress on the ease of doing business, Serbia lags on competition.


Note: the vertical and horizontal lines are median values for the depicted group of countries.
Competition strengthens incentives for innovation, improves access to intermediate goods and services, and directs labor and capital to their most productive use. As a result, competition can raise productivity. Competing firms challenge each other and by doing so create new markets and expand existing ones. Ideally, efficient firms enter markets and grow, and inefficient firms shrink and exit. But competition can be limited by inherent market characteristics (e.g., scarcity), firm behavior (e.g., price-fixing), and government interventions (or lack thereof). Governments can foster competition with pro-competition sectoral regulation, competitive neutrality, and antitrust regulation and enforcement (Table 2).

### Table 2. How can governments foster competition?

<table>
<thead>
<tr>
<th>Minimize distortions from government interventions, market characteristics and firm behavior through:</th>
<th>1) Pro-competition sectoral regulation</th>
<th>2) Competitive neutrality</th>
<th>3) Antitrust regulation and enforcement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower barriers to entry (e.g., lack of access to infrastructure, statutory monopolies, quotas, ban on private investment)</td>
<td>Ensure level playing field between firms, particularly SOEs</td>
<td>Combat abusive conduct by companies that have a dominant position</td>
<td></td>
</tr>
<tr>
<td>End interventions that facilitate collusion or increase costs of competing (e.g., price controls)</td>
<td>Control state aid</td>
<td>Tackle cartels and other types of restrictive agreements between firms</td>
<td></td>
</tr>
<tr>
<td>Reform interventions that discriminate or grant high levels of discretion</td>
<td>Prevent anticompetitive mergers</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Serbia has strengthened its antitrust institutions since 2005. A Competition Law was introduced in 2005, creating the Commission for Protection of Competition. The framework was revamped in 2009 and amended in 2013 to align it to EU standards. Between 2014 and 2019, the Commission reviewed yearly on average 120 mergers and 15 competition infringement cases, of which most dealt with restrictive agreements. The enforcement of competition rules has been focused on private firms, but recently CPC began to investigate and sanction anti-competitive conduct by state-owned enterprises. The development of antitrust institutions coincided with several waves of privatization and progress with other market reforms, such as corporatization of the remaining state-owned enterprises, the introduction of state aid control, and unbundling in network sectors.
Yet significant barriers to competition remain in Serbia. New data show that Serbian markets are more restricted than markets in 23 EU countries, including five STEEs, for which comparable evidence is available (Figure 21). Serbia has also more barriers to competition than the average for four former republics of Yugoslavia. Active state participation in markets creates the most barriers to competition (Figure 22). Public ownership, particularly in sectors in which private enterprise is viable, weak governance of state-owned firms, and inadequate control of state aid account for most restrictions. Gaps in the regulatory process and administrative burdens on start-ups are also more distortive than in the EU. At the sectoral level, while reforms are taking place, markets are not yet fully contestable due to problems with unbundling (electricity, gas), access to infrastructure (rail transport, telecom), tariffs (electricity, gas), price controls (pharma, legal services), formal powers of incumbents (road transport, professional services) and state aid (air transport).

Despite a series of successful reforms, state ownership remains wide-spread and distortive along the value chains. Since the 1990s, Serbia has privatized or resolved over 2,000 state-owned companies. With about 600 enterprises remaining in the hands of the state, ownership by the state is still more widespread than in most countries covered by widely used indicators on competition in product markets. State-controlled companies operated in many sectors where private operations are most viable (Figure 23). For example, SOEs were present in light manufacturing industries such as furniture, cables, and car parts. SOEs were also present in some network sectors, which are private in the majority of EU member states (such as mobile services). This presence often distorts prices and supply along the value chains, reducing exports and productivity growth in connected sectors (Box 3). SOE governance reforms have not been completed.
Box 5. Reducing state presence will facilitate competition and raise value and volume of furniture exports.

The wood and furniture industry took a dramatic turn toward exports after 2008, primarily to developed EU countries. Wood and furniture exhibited one of the highest export growth rates (13 percent) during this period. But as with the Serbian economy at large, though this industry has done reasonably well, it could do better.

Serbia is moderately rich in forests, but it derives little value from each hectare. Of the 2,155 companies that operated in the sector, 696 were exporters, according to a 2016 study. These companies accounted for less than one-third of all firms in the sector but created more than 70 percent of the sector's revenue and employment.

The greatest potential for adding more value to wood products available in Serbia lies at the end of its chain (in furniture). So, why didn’t more companies export? Export grade lumber was found to be in short supply. Domestic companies, who could use more wood for furniture exports, were unable to acquire it.

The biggest issue with raw wood acquisition is unpredictability of supply, which is managed by a state-owned enterprise. Without disclosure of the quantities sold, buyers sold to, or the logic used to allocate raw wood to different buyers, production planning becomes difficult. As a result, Serbia often sells raw or basically processed wood, which is a low-value added, non-sophisticated product, while producers of furniture cannot expand their production to fully meet the existing demand for high value-added products.

In the case of furniture sector, increasing productivity and value-added in the sector can be achieved by significantly increasing transparency and predictability in wood distribution. The state-owned enterprise which dominates wood distribution is not doing this properly. State’s role should either be reduced in this sector, or the practices of the dominant SOE significantly revised and improved to level the playing field by encouraging greater transparency and predictability in wood distribution. This change would send positive ripple effects through the production chain and unleash production of higher-value-added products.

The other opportunity lies in non-production activities such as design and marketing for furniture exports. However, lack of professional staff with secondary education (craftsmen, upholsterers, and carpenters) limits expansion of production in the short-term.

State aid is excessive and misallocated for the benefit of unproductive SOEs. State aid amounted to 6.4 per cent of general government expenditures and 2.2 per cent of GDP in 2017, four and three times higher than the EU average, respectively. Some aid is not reported or reviewed in line with the State Aid Control Law. Between 2014 and 2017, SOEs accounted for 60 per cent of state subsidies even though they generated 19 per cent of value added during this time (Figure 24). A significant portion of these subsidies were given to cover operating losses of unproductive SOEs.34

Box 6. A redesign of SME support programs is needed for higher growth impact.

Various agencies feature a variety of interventions to support SME growth. In total, in 2017 the Government of Serbia dedicated RSD 17.2 billion (approximately €142 million) to the suite of SME support programs. However, most of the programs involve grants or loans for specific outputs such as a certification, loan to purchase equipment, or participation in a trade fair. Many of the initiatives provide small amounts of funding and related support that are unlikely to have a major impact. This scale of support is unlikely to have any impact on Serbia’s SME environment on aggregate.

To increase the impact on economic growth and job creation, there is a need to re-orient some of the SME support programs. There is a need for better targeting, better definition of objectives focusing on market failures, and to significantly improve M&E systems. Overall, should SME programs be deemed necessary based on the overall objectives of state aid, their approach should be geared towards supporting increased capabilities and productivity, rather than targeting any SME. Based on experience elsewhere, programs that target capabilities improvements and other elements that research shows are correlated with firm growth (innovation, exports, and business networks) are more successful in stimulating growth and job creation in the long-run.

Only SMEs that are constantly improving and adding new capabilities will be able to grow and retain this growth. Initiatives that are just providing inputs (e.g., cheap loans, machinery) without improving SMEs ability to use them will often not result in any real change in SME performance. While it is nearly impossible to identify ex ante whether or not a firm will grow, those that are increasing their capabilities and aim to increase their productivity will be better-positioned to grow, or at a minimum remain competitive if faced with stronger competition.

Drastically reducing state aid and improving control and measurement of impact would improve its growth impact. Reducing state aid to the level of EU countries would free up 1.5 percent of GDP for more productive use. It would also increase competition by leveling the playing field between state-owned and private companies. While direct support to firms is not recommended, the state should intervene when there are market failures (such as unequal access to finance). These firms could also benefit from horizontal policies that encourage innovation, combined with actions to reduce disproportionately high administrative burden on start-ups. Strategic changes would also be needed in how the state supports SMEs (Box 4). In addition, while it has served well and helped create more jobs, the FDI attraction strategy could be re-focused on attracting better and more productive firms in sectors with high potential spillovers to the domestic economy (see Box 5).

Reforms that foster competition can have a significant impact on growth. In Australia, the implementation of the National Competition Policy increased GDP by at least 2.5 per cent between 1992 and 1999.\(^{35}\) In Ukraine, eliminating restrictions to competition in the services sector led to an increase of 3.6 per cent in total factor productivity in the manufacturing sector.\(^{36}\) In Serbia, leveling the playing field between SOEs and private firms would yield the most benefits. These changes would include a drastic cut in state aid, strengthening state aid control, privatizing or corporatizing the remaining SOEs, and insulating the rulemaking process from capture through wider stakeholder consultations and stronger impact assessment. Ongoing market reforms in network sectors, primarily energy, transport and telecom, and lower barriers in professional services could complement these changes and reduce input costs for firms. Finally, stronger enforcement of competition rules, particularly more efforts to detect cartels and anti-competitive agreements, would also help to limit overcharges.

---

35 The Australian government implemented a broad range of economy-wide (e.g., corporatizing SOEs, changes in antitrust regulations) and sector-specific reforms (e.g., unbundling in electricity, tradeable water allocations). The estimate of 2.5 per cent is conservative and reflects productivity and price changes in key infrastructure sectors in the 1990s. Australian Productivity Commission. 2005. Review of National Competition Policy Reforms. Canberra.

Box 7. Greater foreign direct investment impact on productivity is possible.

Between 2014 and 2017 foreign investment created 43,000 jobs, 27,000 of which were in manufacturing. The auto industry is a clear example of impactful FDI. The production of the FIAT 500L in Serbia in 2013 meant a total factor productivity boost of 6 percent in manufacturing. Separately, a vibrant vehicles parts sector has emerged, supplying to car plants in Hungary, Romania and Slovakia.

Box Figure 1. The start of the production of the Fiat 500L saw a jump in productivity.
Total factor productivity growth, 2010-17

Box Figure 2. New FDI firms saw lower productivity.
Average productivity and employment in firms aged 0-1 years, 2013-2017

FDI has led to productivity spillovers of firms that supply to them and of firms in the same industry. But many FDI firms rely little on domestic firms for their supplies and can import over 90 percent of their supplies, meaning that these spillover effects fail to materialize, especially from exporting FDI firms, who source only 9 percent of their inputs from domestic firms.

Recently, productivity of FDI has fallen (see Figure 15 in Section on Productivity) due to growth in lower value-added and less productive industries. Currently, the fastest-growing FDI firms are in manufacturing industries such as clothing and footwear, vehicle parts, administrative and support services, and retail. In addition, average productivity of new FDI entrants declined by 30 percent between 2013 and 2017, which is more than the fall of domestic entrants (Box Figure 2).

FDI growth in lower value-added industries and limited linkages with domestic firms suggests that a course correction in FDI incentives could bring higher growth benefits than the current set-up. Current schemes incentivize primarily job creation, an artefact of past high unemployment and Serbia’s unknown status as an FDI destination. Today’s Serbia needs incentives aimed at productivity growth through fostering growth in higher value-added industries and creating spillovers.

Serbia is at a crossroads. Although current growth rates are improving incomes in Serbia, 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.

With what we call the New Growth Agenda, supported by sustained effort to maintain macroeconomic stability, Serbia can grow at 7 percent a year, on average, 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 that could make this level of economic growth possible. Improving on these dimensions would bring highest benefits for growth:

- **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 the 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.

37 Growth impacts are based on model simulations, see Figure 2 and Box 2.
• **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.

Along with maintaining macroeconomic stability, this policy agenda would constitute a national declaration that Serbia intends to seize the opportunity it has created for itself. None of this will come easy. In 2019, the global environment has deteriorated; leading indicators suggest a further slowdown in global growth and trade in the near term. But Serbia can safeguard its hard-won macroeconomic stability and take its economic transformation to the next level. Reforms will at once promote growth and build needed resilience for the coming period and beyond. But this goal will elude Serbia if it does not construct a better foundation for faster growth. The challenge is not only economic. It requires courageous, decisive and bold political commitment as well as strengthening in government effectiveness and accountability.
Serbia Country Economic Memorandum (CEM) 2.0, “Serbia’s New Growth Agenda”

The report and associated papers outline a strategy that could seize the opportunity provided by the country’s successful macroeconomic stabilization to boost growth to 7 percent a year, nearly double its current rate of 3-4 percent. Serbia is well-positioned to turn itself into a fast-growing, sophisticated, modern economy, that, driven by its private sector, catches up rapidly with peers in Central and Eastern Europe and converges with the EU. With an ambitious new growth strategy, this vision of Serbia is entirely within reach.

Visit us at: www.worldbank.org/serbia-cem