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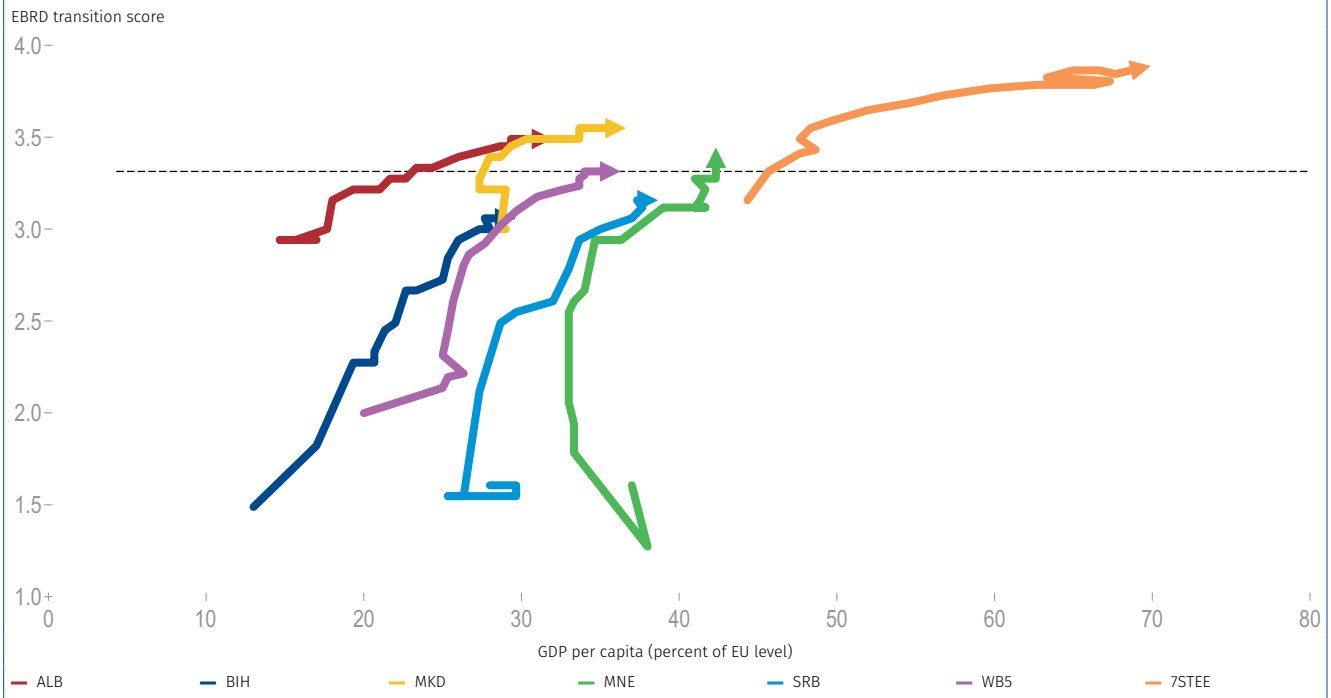
Serbia's New Growth Agenda

At 3–4 percent a year, Serbia is not growing as fast as it could. Yet, it is well-positioned to turn itself into a fast-growing sophisticated modern economy, driven by its private sector. A new wave of structural reforms would be necessary to achieve this. Under a new growth strategy Serbia could speed up growth, enable catch up with its peers in Central and Eastern Europe and hasten convergence with the EU. If Serbia achieved the level of Germany's performance in such areas as financial sector depth, human capital, and product market competition, it could grow at 7 percent a year, doubling its income in a decade.

Serbia can grow faster than in the last decade. In the early years of transition, after the conflicts and economic mismanagement of the 1990s, Serbia had progressed fast on the path of economic reforms. Serbia experienced a period of above 6 percent yearly economic growth, and later begun the process for accession to the European Union. But after the global financial crisis of the late 2000s, its annual growth averaged a mere 1.2 percent.[1] As a result, the Serbian economy is still smaller than in 1990. At the same time, transition economies of Central and Eastern Europe are now 80 percent larger than they were in 1990 while the other small transition economies of Europe (7STEEs) are 60 percent larger.[2]

To do that, Serbia needs a new growth strategy. Although private firms and exporters are increasingly driving growth in a broad range of sectors, the incomplete transition to a market economy is making it difficult for the private sector to accelerate economic growth. Yet, Serbia is only a short distance away from the point at which the critical mass of reforms started to substantially accelerate growth in other small transition economies. To grow faster, a clear, bold and evidence-driven strategy is required.

The first two waves of structural reforms brought Serbia to the level where other small transition economies of Europe were in 1996. A third wave is required to reach the point at which cumulative reforms pay off in rapid growth as seen below for 7STEEs, Albania and North Macedonia.



Source: World Bank (2018) Revving Up the Engines of Growth and Prosperity in the Western Balkans, World Bank, Washington DC.
Note: 7STEEs include Bulgaria, Croatia, Estonia, Latvia, Lithuania, Slovak Republic, and Slovenia.

But what reforms will bring the "biggest bang for the buck" in terms of growth? Under its ongoing Country Economic Memorandum "Serbia's New Growth Agenda", the World Bank is working closely with the Serbian government to estimate the impact of selected structural reforms on GDP growth. We assess the effect of reforms separately on capital accumulation, labor utilization and productivity, the three main supply-side channels through which to increase economic growth. Overall, pro-competition reforms and improvements in the quality of human capital boost long-term growth through labor and efficiency channels, while EU accession positively impacts growth by boosting capital deepening. Deeper regional and global trade integration would also help push up growth.

1 Average annual growth rate in 2009–2018.
2 Based on preliminary numbers for 2018 published by the Eurostat. 7STEEs include Bulgaria, Croatia, Estonia, Latvia, Lithuania, Slovak Republic, and Slovenia.

Is it possible for Serbia to double its income in a decade? The analysis below indicates how Serbia can add over 5 percentage points to its average economic growth over the last decade (1.2 percent), bringing overall growth to 7 percent sufficient for doubling income in a decade.[3] Four areas on the domestic front would require comprehensive, timely and sustained reform: 1) deepening financial sector development, 2) enhancing the skills of its labor force, 3) strengthening competition in product markets; and 4) increasing government effectiveness. Other areas where reforms would have substantial effects on GDP growth include technology absorption, labor market regulations, and restrictions on trade and global integration.[4]

New wave of structural reforms could bring Serbia's growth to 7 percent a year.

Source: Rovo (2019) background paper for the Serbia New Growth Agenda CEM, World Bank (2019).
Note: For each policy variable, the chart shows the distance of Serbia from the frontier (Germany) and the estimated increase in annual growth rate of real GDP in the process of closing the distance in twenty years (forty years for government effectiveness), together with the supply-side channel through which GDP is affected. See detailed explanation of variables in footnote 4.

Financial sector: In the financial sector, micro, small and medium enterprises (MSMEs) face challenges in accessing suitable financing; these challenges are particularly severe for micro-enterprises and start-ups. MSMEs in Serbia constitute over 99 percent of all businesses and employ over 65 percent of the labor force. While established SMEs are relatively well-served by commercial banks, micro enterprises face challenges when seeking bank financing as banks' lending standards are overly strict, requiring good credit history, collateral, and large turnovers. Other sources of financing that may be more appropriate for the needs of SMES are not well-developed. These include factoring, leasing, and private equity/venture capital financing.

Skills: In human capital, Serbia needs to focus on education quality and relevance. 29.3 percent of companies in 2017 indicated problems with hiring new workers, mostly due to skills shortages, compared to 13.7 percent in 2014. Consistent with this result, the returns to tertiary education are high, at 14 percent. Serbia's education and training system needs reforms to build skills valued by today's labor market. Some immediate priorities are to: 1) finance tertiary education needs on a performance-oriented model based on a recognized system of quality assurance;

3 Potential growth rate would in this case increase to 9 percent.
4 Variables on the right of the y-axis indicate policy areas where Serbia lags behind the frontier (Germany): financial development, measured by credit to private sector as a percentage of GDP (WDI); regulatory quality (WB-WGI); government effectiveness (WB-WGI); availability of latest technology (WEF); human capital, which measures return to education (Penn World tables); CBR working time regulation index, which measures the extent of protection in terms of working time regulation (Cambridge CBR); trade-weighted average applied tariff rate (WEF). Variables on the left of the y-axis indicate areas where Serbia performs better than the frontier: number of hours to start a business (Doing Business); top marginal income and payroll tax rate (Fraser). Variables not included because of relatively small effects are: energy use per capita; internet use.

2) develop education strategy to enhance market relevance and an integrated information system for education monitoring and providing timely information on labor market prospects to help individuals in selecting careers or degrees to pursue; 3) rebalance away from over-enrollment in vocational education toward modernizing general education; 4) optimize the school network to raise efficiency and focus on quality; and 5) promote innovation and entrepreneurship development in tertiary education so graduates develop the mindset and tools to launch new enterprises.

Competition policy: On competition in product markets, international experience demonstrates that a comprehensive national competition policy can bring substantial economic gains, both economy-wide and sector-specific. Competition can be limited by market characteristics, firm behavior, and government interventions. Anti-competitive government interventions include regulatory barriers and other policies, such as subsidies and other forms of protectionism. In Serbia, 65 percent of regulatory distortions in product markets are introduced by government, especially by widespread state ownership and special treatment that SOEs enjoy—such as subsidies, access to credit, and low competition. The government can support competition by rolling back or avoiding anti-competitive interventions. Regulation is another area where improvements will be useful: through simplification, increasing transparency in the legislative process, strengthening stakeholder consultations, the implementation of regulatory impact assessments, reduction in administrative burden, as well as unbundling monopolies in the key input and network sectors (such as energy, transport, and telecoms). All help guard against interest groups capturing the regulatory process and promoting protectionist policies.

Government effectiveness: Despite its comparatively large state, only half of Serbia's population is satisfied with the quality of public service delivery. This is comparable to satisfaction levels in Central Asian countries and well below the 70 percent in the 7STEEs. The government effectiveness indicator captures the perception of the quality of public services, the degree of independence of the civil service from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. Serbia's wide-ranging public sector reforms in the last decade (such as rightsizing of the public sector and public wage system reform) have had an impact on its government effectiveness ratings, making incremental gains in its WGI scores (from 58 in 2014 to 61 in 2017).[5] Much more can be done, including on tax administration, judicial processes, public procurement, land administration, among others. Improving government effectiveness takes time[6] because building institutions and establishing credibility requires sustaining performance across government turnovers and cyclical events such as elections or economic downturns.

Serbia is well-positioned to turn itself into a fast-growing, sophisticated modern economy, driven by its private sector. The four reform areas mentioned above offer opportunities on the domestic side to increase the potential of the economy and bring growth dividends trickling over time. And it is growth that Serbia needs for improving people's incomes and prosperity. For example, if 5 percentage points are added every year to the current growth rate, Serbian citizens will be doubling their incomes in a decade.[7]

5 According to the Worldwide Governance Indicators (WGI, 2017), Serbia is nearly on a par with Bulgaria (64), and ahead of Romania (46), but 10–12 points below Croatia and Poland (73 and 74 respectively.

6 This indicator is quite broad and encompasses institutional issues that change only gradually, so we assume that Serbia will converge with Germany in 40 years.

7 If Serbia grows at 5-6 percent a year, it could double its income in 15 years.