

REFORMS IN SERBIA: ACHIEVEMENTS AND CHALLENGES



Center for Liberal-Democratic Studies

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Foreword

The ship called Serbia is sailing through rough waters, as always. Economic and social situation has certainly been improved during the last decade, but dissatisfaction with the achieved results is widespread among both the general public and the experts. It is believed that many rocks lurk beneath the water and that caution is a reasonable strategy. The main reason for caution is that politics, both domestic and external, has more often than not been an obstacle to the economic and social progress.

The book in front of the reader represents an attempt by the CLDS team to show, in an unbiased way, where Serbia is in terms of economic and social situation, what the risks are and how could be proceeded with reforms. Therefore, short texts present and analyze the process of institutional reforms in Serbia, economic and social policies and their achievements, current problems and some proposals for remedying them.

It is our strong belief that difficulties can be overcome and that faster economic and social development is possible. It remains to be seen whether that will be accomplished.

Boško Mijatović

Key Macroeconomic Imbalances and Risks

High rates of economic growth recently recorded by the economy of Serbia have been achieved amidst increasing macroeconomic imbalances: dual deficit, rising inflation, low domestic savings and increasing external debt. Indicators of economic vulnerability of Serbia have far exceeded the level recorded in the countries that experienced financial crisis, which certainly presents a good cause for concern and for an assessment of the risk that the crisis may occur here as well. Certainly, this risk is mitigated by the EU convergence processes, as well as by the increase in foreign direct investments; however, poorly developed institutions and soft budget constraints, which is still predominant in the business environment of Serbia, maintain this risk at a rather high level. The purpose of this chapter is to examine the vulnerability indicators and provide an assessment of the level of risk Serbia is exposed to in this moment.

The vulnerability indicators show that Serbia is aggravating its position, primarily due to a strong increase in the current account deficit. Compared to other countries, the vulnerability indicators are still more favorable than in the region, but are dramatically deteriorating in Serbia, although they are still at a rather “safe” level.

INCREASING FISCAL IMBALANCE

1. For the last eight years of transition, Serbia has significantly improved its fiscal system. Numerous quasi-fiscal activities of the central bank have been ended, special budgetary funds and “special” accounts eliminated and the Treasury formed, thus creating a basis for pursuing sound fiscal policy. Delays in the payment of pensions and children’s allowances now belong to the past, and the outstanding payments and frozen foreign currency savings have gradually been almost completely repaid. (As late as) at the beginning of the fifth year of transition, the value-added tax was introduced as well, whereby the initial reform of Serbia’s fiscal system was completed. In the 2000–2005 period, the Republic budget was passed under the watchful attention of the International Monetary Fund (IMF) whose consent was one of the tacit but key assumptions for passing the budget. Since 2006 Serbia has had no arrangement with the IMF. According to the

Table 1
Vulnerability indicators for selected countries and regions
(in percent of GDP, arithmetical mean is shown for regions)

	Southeast Asia 1996		South-east Europe		Bulgaria		Croatia		Romania		Serbia	
	2006		2006		2006	2007	2006	2007	2006	2007	2006	2007
Fiscal deficit	1.1		-0.7		3.5	3.5	-3.0	-2.8	-0.5	-2.3	-1.5	-1
Current account deficit	-4.4		-11.3		-15.5	-20.2	-7.8	-8.5	-10.3	-13.9	-12.4	-16.5
External debt (total)	49		68		78.4	87.6	89	...	42	...	61	65.1
Public debt	24		31		25	21.3	41	...	19	...	39.6	37.6
Reserves/short-term debt	59		167		135	138	100	...	125	...	717.3	729.7
Reserves/(short-term debt plus c.a. deficit)	...		85		76	82	74	...	64	...	219	164.3
GDP growth	7		6.1		6.3	6.1	4.7	5.7	7.9	6.0	5.6	7.5
Inflation	5.9		7.4		7.4	7.5	3.2	2.8	6.5	4.4	12.7	10.1

Source: IME, WP/07/236, IMF Data and Statistics for 2007, IMF CR for selected countries for 2007, NBS for Serbia

official methodology of the Ministry of Finance, this has not caused loosening of fiscal discipline in Serbia. However, according to the IMF methodology, since the termination of the IMF arrangement, Serbia has been recording a fiscal deficit.¹

Table 2
Consolidated public spending in Serbia, 2001–2008

	2002	2003	2004	2005	2006	2007	2008 I–III
Gross Domestic Product	1020	1171.6	1431.3	1747.5	2042.0	2393.0	
PUBLIC REVENUES, bln RSD	407	472.7	589.4	701.7	846.9	988.6	
Total revenues, as % of GDP	39.9%	40.3%	41.2%	40.2%	41.5%	41.3%	
PUBLIC EXPENDITURE	438.6	485.3	576.5	665.4	811.8	977.7	238.2
Total expenditure, as % of GDP	43.0%	41.4%	40.3%	38.1%	39.8%	40.9%	
Consolidated deficit/surplus	-31.6	-12.6	13	36.2	35.1	10.9	20.7
Deficit / surplus (MoF method.), in % of GDP	-3.1%	-1.1%	0.9%	2,1%	1,7%	0,5%	
Deficit (IMF methodology), %GDP	-4,2	-3	0	0.7	-1.5	-1*)	

*) estimate

Source: Consolidated General Government Revenues and Expenditures, 6.5.2008, MoF web page, IMF Country Report No. 08/55

2. The existing share of public spending of over 40% of GDP is too high and unsustainable, and the internal balance in the medium-term critically depends on fiscal sustainability. The expansionist fiscal policy from the previous years led to an accelerated increase in real wages (15.3% per year on average in the last five years, while the annual GDP growth in this period was about 5.6% on average).²

- 1 The differences result from the different treatment of non-tax revenue originating from privatization, which the IMF does not include in tax revenue, while according to the IMF methodology the expenditure increases by the payment of debt to pensioners.
- 2 At the same time, in the first three years (2001–2003) the average real increase in wages was 20%, while in the 2004–2007 period it decreased to 12%. A high increase was recorded in the sub-period May 2006–May 2007 (see Table 3).

Such an increase in wages and spending gave a significant contribution to the high foreign trade deficit, which was finally transferred to double-digit inflation and threatens to seriously endanger macroeconomic stability. The deficit itself was originally financed by grants and later by foreign borrowing and privatization proceeds.

The maintenance of oversized budget thus proves to be harmful in two ways: not only that it crowds out private investment and decelerates economic growth but also an excessive portion of privatization proceeds goes to consumption, which presents a classic example of disinvestment. In addition, the privatization proceeds are drying up, so there are announcements that a liquidity deficit could appear in September, which may only be avoided by a larger privatization.³ For the time being there is not even a mention of reducing any expenditures for the purpose of avoiding the liquidity deficit.

3. A special vulnerability here is that the fiscal deficit would significantly endanger external macroeconomic stability. The IMF research shows that an increase in fiscal deficit in Serbia by 1% of GDP increases the balance of payments deficit by the same percentage, which makes the problem rather complex (IMF Country Report No. 08/55). Similarly, the expected decrease in the privatization proceeds and the consequent increase of the fiscal deficit would create a need for government borrowing for the purpose of covering the fiscal deficit as well as for the purpose of repaying the public debt. In that case, the absence of fiscal adjustment could result in a relatively rapid increase in Serbia's public debt.

4. The basic reason of maintaining high public spending and increasing fiscal deficit lies in the political situation in Serbia, where coalition governments do not last long, while spending a good portion of their term in searching how to increase political rating and prepare for the next election campaign. Even the surplus from the first half of 2007 was realized solely due to the regulation on provisional budget financing, which caused an (unintended) fiscal tightening. However, immediately after the government formation in the second half of the year the expenditure was more than compensated for. Like last year, a surplus of RSD 7 billion was recorded in the first four months of 2008 as well. It is realistic, however, to assume that after the government formation in the second half of this year the last year's scenario will be repeated and that the previous saving will rapidly melt away. In addition to that, the announcement of a "socially responsible government", which would have a task to make the average pensions reach 70 percent of the average wage would lead to a further increase in expenditure in 2009 by RSD 114 billion above the expenses specified for these purposes by current

3 For example, according to the Minister of Finance, the sale of the NIS oil industry company by the end of the year would prevent that liquidity deficit.

regulations.⁴ In that scenario, every sixth dinar of the budget would go to pension increase, which would either require more considerable cuts in other budget expenditure or lead to government borrowing and further inflation increase.

5. In recent years, budget capital expenditure increased its GDP share from 1.9% in 2005 to 3% in 2006 and to 4% in 2007, which relates to the National Investment Plan. The initially prepared 2007 budget did not include expenditure related to the National Investment Plan, and when upon the IMF insistence this expenditure was included and the proceeds from the sale of the third mobile telephony license were excluded from the revenue side, the budget turned from the surplus of about 0.5% of GDP into a deficit of over 1% of GDP (according to the IMF methodology). Extra-budgetary public investments are planned as well: government external borrowing (EUR 740 million for the modernization of clinical centers, improvement of irrigation systems and similar), issuance of guarantees for borrowing by public companies (EUR 840 million primarily for JP Putevi Srbije – Public Road Management Company and JP Železnice Srbije – Public Railway Company). Increase in public investments (and spending) on this basis, according to rough estimates, will be about 1–2% of GDP.⁵

6. Just like the increase in capital expenditure, the growth in nominal wages during 2006–2007 was primarily caused by political cycle and contributed to the previous government winning a new term. At the same time, the wage increase was not equal for all sectors. The lowest growth rate was recorded in the manufacturing industry (of about 20 percent), which is still higher than the productivity growth, which, according to the IMF estimate, was 13–14 % in the same period⁶. In the public sector, the increase in real wages in this period was almost 30 percent, while here the productivity growth almost exclusively due to layoffs, whereby the employment in this period decreased by two percentage points.⁷

4 The increase in expenses by RSD 114 billion relates to the increase in relation to pension expenditure under current regulations. It consists of two components: the first is (one-shot) increase in pensions by one fourth; the second is the changed indexation system, according to which future movement of pensions would be indexed solely to wage movement.

5 Source : FREN http://www.fren.org.yu/docs/NDE_Nova-inflacija_DEC07pdf.pdf

6 IMF, Serbia's Unsustainable Wage Increases – Who Will Pay? September 2007, <http://www.imf.org/external/country/SCG/rr/2007/090107.pdf>

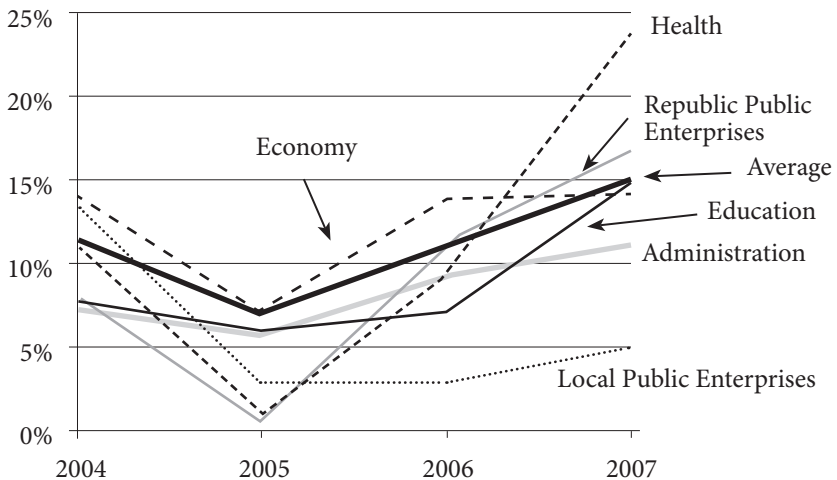
7 According to the RSO data – Semi-annual report on employees and employee wages RAD-1/P

Table 3
Pre-election increase in real wages, May 2007–May 2006
 (дванаестомесечни раст плата, у %)

All sectors	26
Insurance	55
Health and social care	42
Post and telecom	42
Electricity	39
Construction	34
Air transport	30
Education	28
Banking	26
Manufacturing	20

Source: RSO (ZP11), IMF, Serbia's Unsustainable Wage Increases – Who Will Pay? September 2007

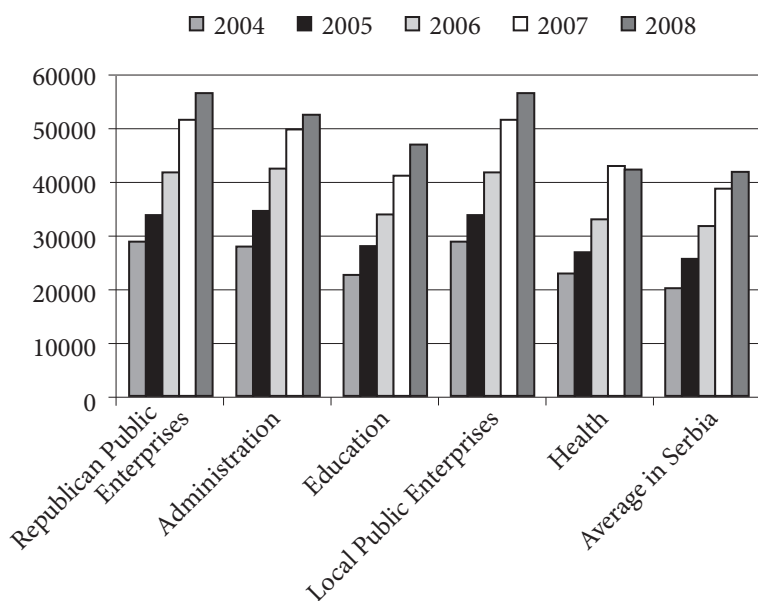
Figure 1
Growth in real gross wages 2004–2007



Source: RSO data. Wages in public sector are higher because part of the wages is financed from own income.

However, their term lasted only one year, so in May 2008 the country faced a problem of sustainability of macroeconomic stability in near future. The double-digit inflation, the high balance of payments deficit, the appreciated dinar exchange rate and great political promises that they will continue with populist policy almost present an ideal recipe for liquidity crisis, which would distance foreign investors even more from the intention to invest in Serbia and thereby fill the budget (in the short term) and increase employment, income and possibly reduce the balance of payments deficit (in the longer term).

Figure 2
Gross wages in dinars, 2004–2008



Source: RSO. Wages in public sector are higher than those presented because part of the wages is financed from own income.

7. Regardless of the official announcements of reduction of public spending share in GDP in 2008, the chances that it would be realized are poor. The reform of the pension system, health and public administration deeply infringes upon the acquired rights, so its implementation requires strong political will and at least a consensus of government, employers and trade unions in principle, which is currently unimaginable. The announcement of fiscal relaxation and full affirmation of the concept of welfare state in the election campaign leave little room for restrictive fiscal policy once after the government is finally constituted. However, it would be necessary to reduce the share of wages as well as

the share of subsidies and expenditure for the purchase of goods and services in GDP. Elimination of hidden deficits and non-payments within public companies would also help further reduction of the share of public spending, which is necessary primarily because this policy permanently “dooms” the public spending to remain low in absolute amounts. Therefore, a reduction of budget spending presents an imperative, whose delay will be very expensive.

8. **Privatization of public enterprises** or introduction of hard budget constraint remains an imperative for sustainable development, observed from the macroeconomic level. Privatization is necessary because in Serbia there is a number of privileged state-owned companies that call themselves “strategic” and to which, as long as they are state-owned, the strict climate of bankruptcy and liquidation will not apply, while the culture of non-payment and “clientelism” may not be rooted out. Experiences of successful transition economies show that the soft budget constraint was not completely abolished until the privatization of large public companies. However, the privatization of these companies rises numerous questions related to the methods, procedure, scope and dynamics of privatization, pre-privatization restructuring, desirable industry structure and appropriate economic regulation, and the answers to these questions vary from one infrastructure activity to another. Furthermore, from the viewpoint of political economy of such privatization, the political parties that manage them at that moment become losers, and therefore party officials immediately react to any announcement of the possibility of privatization with explanations that such solutions are “bad for the country”, whatever it may mean, so strong opposition to privatization of public companies may be expected.

INCREASING EXTERNAL IMBALANCE AND DEBT TREND

9. Since the beginning of transition, the **current account deficit** has increased from 10% (previously considered to be the critical medium-term limit of sustainable current account deficit) **to 16.3% of GDP**. The coverage of imports by exports does not exceed 50% (during 2007 it decreased from 46.8 to 45.7 percent). Compared to other countries of similar size, Serbia obviously belongs to relatively closed economies: the total volume of Serbia’s trade does not reach even 80% of GDP, while in the other countries it ranges between 130–170% of GDP. Except in the remittance account, where Serbia regularly achieves a high and increasing surplus, a deficit was recorded in all other accounts.

Table 4
Serbia's balance of payments current account balance 2001–2007

	2001	2002	2003	2004	2005	2006	2007
Foreign trade deficit, mil.€				-5311	-4280	-4982	-6414
(% of GDP)	-24.5	-25.2	-23.6	-26,83	-20.39	-20.01	-20.91
Current account				-2197	-1805	-3137	-4999
(% GDP)	-4.6	-8.9	-7.3	-11.1	-8.6	-12.6	-16.3
Memo: Foreign reserves, mil.€	1320	2175	2840	3117	4935	9025	9369 ⁸

Source: NBS and RSO

10. The key source of large foreign trade deficit consists of (still) low exports, which at the beginning of the transition were barely 15% of gross domestic product. In 2007 the exports reached a third of GDP, while the imports reached a half of GDP (normal values in the countries of similar size are between 50 and 80% of GDP), which means that the exports do not reach half the share in GDP that would be necessary in a growing, open economy. A positive tendency, however, is that the exports record a very rapid increase of over 20 percent per year, which constantly increases the foreign currency inflow and has a favorable impact on the possibility of repaying increasing credit obligations in the following period. (compare the Table in Item 13), Exports underwent significant changes towards deindustrialization. The structure of the first ten products exported to the EU changed radically as well: the exports of machines and car parts decreased from over 15% to under 5%, while the agricultural products increased their share from 4.8 to over 20 percent. The leading export products have been iron, steel, tires, aluminum sheets, sugar, corn etc.

The increase in exports of agricultural products came as a result of a preferential status that Serbia has in the EU market, as well as a liberalization in trade with the West Balkan countries. The surplus in the trade in finished textile products is also a consequence of the signed Agreement with the EU and the preferential status our goods enjoy. However, the increase in the world prices of base metals and increase in the economic activity in the world also contributed to the accelerated increase of Serbia's exports. At the top of the list of imported products are oil and gas, passenger cars, medicines etc. The current poor exports structure is however helped by the fact that terms of trade are changing in favor of primary products, but unfortunately the most important imported product of Serbia – oil – will become more expensive by approximately

8 In March 2008 foreign reserves amounted to 9.553 billion euros..

the same percentage. The largest export markets of Serbia are Italy, Bosnia and Herzegovina and Montenegro. At the same time, the largest imports came from Russia, Germany and Italy.

11. The balance of payments current account deficit, which in the last twelve months increased from 3 to 5 billion euros (from 12.6% to 16.3% of GDP) does not need to be considered *a priori* an ultimate sign of economic performance deterioration.⁹ Although it is certainly clear that the balance of payments deficit implies that the economy invests more than it is possible to generate from domestic savings (whether private (S-I) or national (T-G))¹⁰, this relation cannot explain the dynamic connection between savings, investments, growth and debt. Therefore, in interpreting the balance of payments deficit in the transition countries, it is best to use the relation

$$CAD=(Y^*-Y)-(I^*-I)-(G^*-G),$$

where the Y is gross domestic product (GDP) and where the *asterisk* designates long-term level of the variable (compare Obstfeld and Rogoff, 1996). It may be expected that a country has a current account deficit (CAD) if either GDP or investments or public spending – or all of them – are above their long-term level. All three phenomena are in fact related to the first phases of transition, where both domestic product, investments and public consumption stay above their long term level. It becomes obvious also that a fiscal reform could well lead to a decrease in current account deficit. For all these reasons, a high level of current account deficit in the first phases of transition should not be considered an anomaly but a phenomenon that inevitably accompanies the process of catching up with developed economies.

Analyses of financial and currency crises in transition economies (Russia, the Czech Republic, Bulgaria, Romania, Albania) confirm such approach. As it turns out, the crises did not occur as a current account problem but as a result of insufficient supervision in the banking system (Albania, Bulgaria), or as a result of absence of reform of tax system and government spending (Romania, the Czech Republic), while Russia, even had a current account surplus, and the collapse did not occur as a balance of payments crisis, but rather as a the self-fulfilling prophesy that resulted from the expectation that the Russian state would eventually stop servicing the increasingly heavy burden of interest on debts. (compare Sanfey, FREN 10/08).

9 It would have classified Serbia among the absolute record holders in terms of the level of balance of payments deficit in the region, if a record deficit of 30% of GDP had not been realized in the meantime in Montenegro.

10 Current account deficit of a country equals the gap between domestic private savings and investments (S-I) on one side, and national savings, i.e. budget deficit (T-G), on the other. The deficit itself is financed by foreign savings, which may be in the form of inflows that increase capital (investment from abroad) or inflows that increase debts, i.e. from external borrowing.

12. The increasing current account deficit is financed from foreign savings, partly in the form of borrowing, and partly by foreign direct investments.¹¹ It is important to emphasize a constant increase in sum of medium-term and short-term loans, which in 2007 reached the level of over EUR 3 billion. The total debt of Serbia in May 2008 was EUR 17.6 billion, of which EUR 11.6 billion was private debt. At the same time, the private sector gradually shifts from official (government) to private sources, mostly to foreign banks that extend loans to their branches in Serbia. This trend causes an increasing concern and raises the issue of sustainability of Serbia's external debt.

Table 5
Indebtedness level criteria and Serbia's debt in 2001–2007

	High indebtedness	Average indebtedness	Low indebtedness
Debt/GDP	$x > 80\%$	$48\% < x < 80\%$	$x \leq 48\%$
Debt/Exports	$y > 220\%$	$132\% < y < 220\%$	$y \leq 132\%$

	Serbia						
	2001	2002	2003	2004	2005	2006	2007
Debt/GDP	94.2	70.9	66.7	57.5	59.1	64.5	64.5
Debt/Exports	456.9	379.5	343	253.6	234.2	228.1	222.5

Source: NBS, Inflation Report, Indicators of Serbia's external position, May 2008

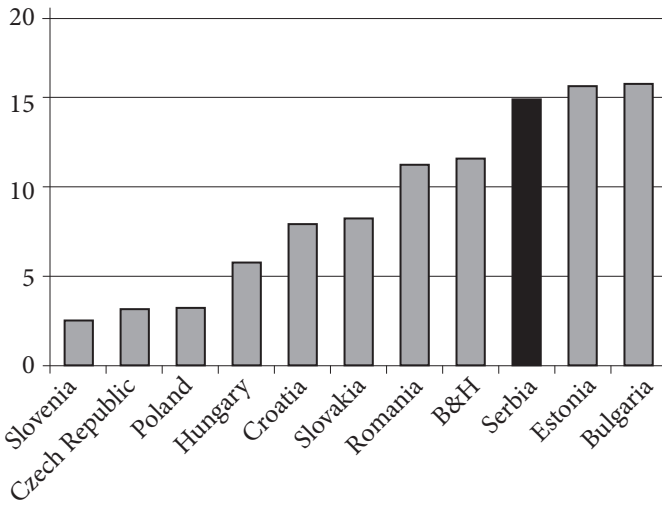
However, according to the World Bank criteria, after 2005 Serbia no longer belongs to highly indebted countries. Despite the still relatively low exports, the capacity of debt repayment has increased sufficiently to classify Serbia among averagely indebted countries. However, attention should also be drawn to the fact that the due obligations have been increasing heavily since 2007, and that this inevitably leads to the deterioration of the external liquidity indicators (debt repayment share in GDP and debt repayment share in the annual exports of Serbia). The estimates of sustainability of external liquidity show that Serbia's exports must increase at a rate higher than 15% per year in order to generate enough funds for servicing due repayments.¹²

13. **Liquidity risk** In addition to total debt, when examining vulnerability of an economy it is of interest to determine the liquidity risk, primarily because the economy that faces a high bill in near future will more probably fall into a crisis than the economy that

11 During 2006, foreign investments more than covered the deficit, so the room for borrowing was thus significantly expanded.

12 So far, exports were growing by 20%, and same growth is estimated in future.

Figure 3
Current account deficits in selected transition economies, in % of GDP, 2006



Source: EBRD (taken from QM no. 10, text Spotlight on 1, P. Sanfey, “Current account deficit in Serbia: Causes, Concerns and Consequences”, December 2007)

should repay the same level of debts in a longer term. However, as shown by Tables 1 and Table 5, Serbian foreign reserves exceed many times the amount of short-term debt (the situation is at least three times worse in all other countries observed), and foreign reserves are higher by as much as 25% than the sum of the short-term debt and total current account deficit. Therefore, this risk may not be considered significant in Serbia, although any further deceleration of foreign reserves growth would present a very serious signal of increase in vulnerability of the Serbian economy.¹³

14. Most foreign direct investments in Serbia come through privatization. The FDI level reached a record USD 5.5 billion during 2006, and then (for the first time) exceeded the amount of the current account deficit, but the situation may hardly be repeated in future years without an increase in the share of greenfield investments. The investment structure is also important – namely, whether these investments are directed to the tradables sector (where they increase productivity and exports) or to the non-tradables sector. Although productivity gains do happen in nontradables sector as well, no

13 Foreign trade imbalance is still covered by external borrowing and foreign direct investments, so the NBS foreign reserves continued to increase. However, the increase in the NBS foreign reserves in 2007 was four times lower in the absolute amount than in 2006, which may indicate future problems in covering the current account deficit

Table 6 External position indicators of Serbia

	2001	2002	2003	2004	2005	2006	2007	Q1 2008	
EXTERNAL LIQUIDITY INDICATORS (IN %)									
Foreign reserves / Imports of goods and services (in months)	3.1	4.5	5.3	4.5	5.9	9.6	8.3	8.0	
Foreign reserves / Short-term debt	114.1	223.5	336.3	424.9	385.9	717.3	729.7	892.0	
Foreign reserves / GDP	9.9	14.4	17.5	17.3	22.2	39.1	34.9	34.6	
Debt repayment / GDP	0.8	1.3	2.0	3.8	4.5	6.6	9.8	18.0	
Debt repayment / Exports of goods and services	3.7	7.1	9.1	16.8	17.9	23.5	33.7	50.7	
EXTERNAL SOLVENCY INDICATORS (IN %)									
External debt / GDP	94.2	70.9	66.7	57.5	59.1	64.5	64.5	65.1	
Short-term debt / GDP	8.7	6.4	5.2	4.1	5.8	5.4	4.8	3.9	
External debt / Exports of goods and services	456.9	379.2	343.0	253.6	234.2	228.1	222.5	220.2	
INDICATORS OF FINANCIAL RISK EXPOSURE (IN %)									
Foreign reserves / M1	135.9	143.3	195.3	221.0	291.1	356.5	306.9	346.1	
Foreign reserves / Reserve money	136.3	132.0	168.0	166.2	170.3	177.8	173.9	185.8	
ECONOMY OPENNESS LEVEL									
(Exports – Imports) / GDP	58.7	56.9	61.6	71.0	70.7	78.4	79.7	88.8	
CREDIT RATING									
	Nov S & P: B+	July Standard & Poor's and Fitch: BB	Feb S & P: BB-/ positive: Fitch: BB-/stable	June S & P and Fitch: BB-/stable					

current foreign currency inflow is generated here, which may generate problems in the future. Experiences in transition countries show that investments in the nontradables, particularly in real property, often lead to credit expansion, increase in wages and prices of real property, which leads to further growth of this sector (the so-called Dutch disease). With a consequently increasing imports demand and decreasing exports supply, the current account deteriorates inevitably.

Table 7
Share of foreign direct investments in the tradables sector

	Bulgaria	Romania	Croatia	Србија	CEE	Baltics
Tradables	22	46	36	42	42	20
Nontradables	78	54	64	58	58	80
Trade	13	15	8	14	14	14
Transport	26	12	16	7	7	9
Financial intermediation	20	11	28	18	18	27
Real property	9	6	2	11	11	15

Source: IMF WP/07/236 Vulnerabilities in Emerging Southeastern Europe—How Much Cause for Concern?

15. In analyzing the favorableness of foreign investment arrival – whether through privatization or as a greenfield investment – it must also be taken into account that, from the aspect of external vulnerability, a large inflow of investments into the nontradables sector may be counterproductive in the long term, because it itself may cause an even larger increase in the deficit, although it will certainly be favorable in the short term. Examples of Ireland and Portugal are frequently mentioned in the literature, where Ireland, by attracting foreign investments into the tradables sector (electronics and medicines) increased significantly first the exports and productivity, while wages always lagged behind factor productivity growth. With a decrease in public spending, the investment expansion did not increase the balance of payments deficit – because the savings increased faster than investments, and even a current account surplus was recorded! In contrast to that experience, the large inflow of capital into Portugal went to the nontradables sector, mostly to real property. Since the wage growth exceeded factor productivity growth, the profit margin in the exports sector constantly decreased, and so did the exports sector. With an increasing fiscal deficit, the savings decreased, while the current account recorded an increasingly high deficit and at one moment became unbearably high, so its decrease had to be followed by recession. The experience of Portugal may be very indicative in analyzing

the vulnerability of the Serbian economy, which, like Portugal, constantly pursues the policy of wage increase above TFP, does not reduce public spending, while foreign investments are directed primarily to the nontradables sector.

16. **The problem of external deficit vulnerabilities** will certainly remain topical in Serbia in the following years as well. Among the key hard decisions is the reduction of public spending, i.e. achievement of fiscal surplus and attraction of greenfield investors in the tradables sector. The political instability, however, leads Serbia in a totally different direction, towards an increase in public spending and deficit, with an increasingly uncertain inflow of foreign investors. That would hamper the first recorded trends of increase in exports of machine-building and electrical manufacturing industry, which are a result of greenfield investments, such as the Gorenje factory in Valjevo, as well as of earlier privatizations. At the same time, the investment environment itself, according to the report “Doing Business in Serbia”, ranks Serbia 68th among 175 countries in terms of business conditions, only two places below Hungary, but above Russia, Turkey, some EU countries, Poland, Italy and Greece, as well as Montenegro, Macedonia and B&H, which is certainly a result that would be considerably hampered by a longer political instability.

INFLATION AND EXCHANGE RATE APPRECIATION

17. Unlike most of the former socialist countries, **Serbia did not manage to achieve a single-digit inflation rate even after eight years of transition.** The largest contribution to that in the earlier periods was given by election campaigns, while the greatest barrier to inflation was the IMF arrangement, with constant insistence on greater restrictiveness of fiscal and monetary policy, which certainly contributed more moderate inflation trend than it otherwise would have been.

18. Inflation in 2007 was double-digit (10.1%) and may be attributed to the increase in non-core inflation (electricity, utility services, tobacco products, oil products), exogenous shocks – the world trends of increase in the prices of food products and energy raw materials, but also to the increase in aggregate demand which accommodated these shocks. However, despite the double-digit total inflation, core inflation was 5.4%, hence it remained within the planned range of 4–8%. Deceleration of inflation was primarily caused by the active policy of the NBS aimed at the stabilization of nominal exchange rate, which was conducted more or less successfully during the entire previous year. As a consequence of conducting this policy, the dinar became increasingly overvalued (paragraph 20).

19. Expenditure shocks were registered in the first five months of 2008 as well – the increase in the prices of oil, electricity and food. However, the expenditure increase will not generate inflation if the demand remains inactive. As shown by the example of developed countries, the impact of expenditure shocks on inflation in the absence of demand increase is minimal. The very high demand increase at the end of 2007 was caused by the high increase in public spending in the second half of the year as well as the significant credit expansion, which thus “feeds” inflation generated by the expenditure shocks described.

The NBS tries to hold inflation by sharp increases in the reference rate from 10.75% in January to 15.75% in late May and reducing the money supply (M2) by 7.5% since the beginning of the year. Another mechanism remains for reducing the aggregate demand and that is public spending reduction, which would partly hold credit expansion as well. This is in fact registered in the first months of 2008, when Serbia achieved a surplus in the fiscal account, but concerns remain that 2007 may be repeated, when initial fiscal surplus in the first half of the year turned out to be a deficit by the end of the year.

20. Since food prices will certainly continue growing in 2008, and so will credit expansion, **it is to be expected that inflation in Serbia will accelerate.** However, the increase in food prices in Serbia certainly may not be justified by the increase in the world prices in this area, because the increase in food prices is several times lower in all other neighboring countries (except in Bulgaria). Therefore the causes of price increase in this area are primarily in the area of aggregate demand expansion, and the high level of prices of food products may primarily be explained by the existence of monopolies, especially in retail chains, which again shows that investments in retail trade in Serbia, although belonging to the nontradables sector and being a potential threat in terms of the balance of payments crisis, are very welcome because they may increase competition and lead to a decrease in retail prices to the level in the neighboring countries, where lower prices of food products than in Serbia are constantly recorded. An additional danger is potential wage indexation to the accelerated increase in imported inflation. Since the NBS announced further reduction of inflation in 2008 (with a 3–6% core inflation), the NBS will most likely pursue a restrictive monetary policy, with further appreciation of the dinar. At the same time, one may not exclude new episodes of nominal appreciation, either, which is everything else but a useful move of the Serbian monetary authorities. At the same time, the statements regarding the “market-based fluctuation of exchange rate” contradict sharply the NBS practice by which any exchange rate movement in undesirable direction (depreciation) was immediately interrupted in an efficient manner, with praise and self-praise of the monetary authorities’ efficiency in these situations.

21. One of the important experiences of all successful transition economies is that **acceleration of economic growth cannot be “bought” with high inflation**. It was also confirmed that inflation curbing does not cause recession and that it is precisely the other way round. Numerous researches confirm that the basic determinants of growth were the low inflation rate, public spending reduction and resolute implementation of institutional reforms. What may be a surprise is that the countries that realized better economic results in terms of growth and inflation also record greater equality in distribution.¹⁴ It turns out that the sustainable economic growth is primarily based on macroeconomic stability, inflow of foreign investments and increase in domestic investments, rise in competition and exports and consequent (rather than *ex ante*) increase in income and the standard of living.

22. In mid-2006, as the framework for implementing the monetary policy, the National Bank of Serbia used the **inflation targeting regime**.¹⁵ In addition to the repo interest rate, which is the basic instrument of this regime of monetary policy, the NBS also uses (1) the rate of required reserve and (2) interventions in the foreign exchange market.¹⁶ Experiences of the other countries in transition that use inflation targeting regime show that the strongest impact on inflation is made by the *exchange rate channel*,¹⁷ while the effect of the interest rate channel and the credit channel has not been empirically confirmed so far in Serbia (*Fren QM11*). The use of high rates of required reserve or macro-prudential measures for the purpose of decelerating bank loans was often of short duration. This is because the high demand for loans found direct credit channels from abroad. Therefore it turns out that credit increase is determined primarily by the demand for loans, which is still high, while the room for influencing this increase with monetary policy is rather limited. In these conditions, expansionist fiscal policy may strongly hinder the monetary policy in its effort to keep the prices under control, which in the conditions in which the exchange rate presents the

14 Compare Balcerowicz, WB (2003). In Poland, the Gini ratio increased from 28 to 31, but in Russia the Gini ratio increased from 26 to 51, in Azerbaijan it rose from 29 to 50 and in Ukraine from 24 to 46. Therefore there are grounds for saying that inequality increases faster when the reforms are absent than when they are implemented in an accelerated manner.

15 This regime was introduced by almost all transition countries in Europe. The central bank announces in advance the defined inflation target for the following period, while the key instrument of monetary policy is the reference (repo) interest rate.

16 Although the regime of free-floating exchange rate was introduced, the central bank intervenes in the foreign exchange market each time it estimates that the fluctuations threaten to endanger the financial stability of the market in the short term, because of which it may not be said that there is a free-floating exchange rate nor that there is a predominant role of market forces in exchange rate formation.

17 Admittedly, the exchange rate may be influenced in the very short term by the repo rate level itself, because the banks will place the capital they import from abroad in the repo market whenever the return becomes attractive to them. The exchange rate changes are further transferred through the exchange rate channel to prices.

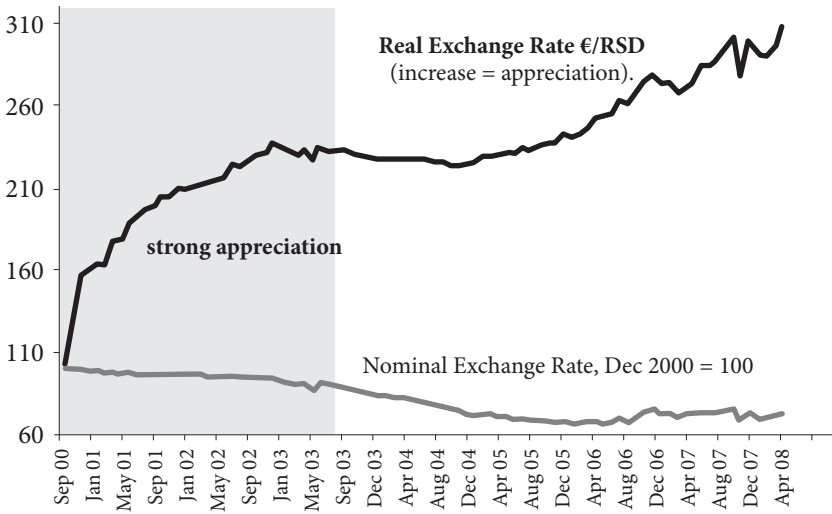
key pillar of the monetary policy not only results in a more expensive monetary policy (expressed by high interest paid on the NBS repo operations), but also causes a high exchange rate appreciation in order to decrease the prices in the short term for the purposes of consistent realization of the NBS target in terms of annual inflation. A strong appreciation, which separates the real exchange rate from its fundamental determinants, decreases the competitiveness of the Serbian economy, discourages exports and causes an increase in the balance of payments current account deficit.

23. Practically all relevant institutions estimated that **the dinar is overvalued**, which is the only logical outcome which expansionist fiscal and moderately restrictive monetary policy. The estimates of overvaluation of real effective exchange rate range in the interval from 5% to 25%.¹⁸ However, since a significant part of the expenditure is indexed in foreign currency, a real depreciation would mean that expenditure not indexed in foreign currency must be considerably lower than the general rate of inflation or, in other words, that they have to be frozen in nominal terms. That would mean a real decrease in that expenditure, with its largest items being net wages and pensions. Experience of the countries that successfully pursued the floating rate policy show precisely that: the increase in real wages in the entire period of intensified exchange rate depreciations was minimal or did not exist at all. It is not probable that there is any political will to start pursuing such a policy in a short-term period in Serbia, so a possible depreciation must be viewed in that light.

24. A depreciation would also significantly worsen the existing unfavorable currency mismatch, i.e. it would significantly decrease the value of (dinar) assets and increase the value of (foreign-currency indexed) liabilities, whereby room would be created for a currency crisis (compare IMF, 2007). Therefore, a sustainable solution for a reduction of currency overvaluation should rather be sought in the continuation of structural reforms, increasing the competitiveness of domestic economy (which is closely tied to FDI) and in a more restrictive fiscal policy, which would lead to the calming of the balance of payments deficit according to the mechanism described in Item 11. Otherwise, the dinar depreciation that would be accompanied by accommodation of aggregate demand could easily cause currency crisis and thereby, in the short term, only worsen the economic environment instead of improving it. On the other hand, it should certainly also be emphasized that the policy of overvalued dinar not only harms present exporters but also desstimulates the arrival the potential ones, thus endangering future external liquidity, new jobs as well as future economic growth.

18 IMF Country Report No. 08/54, *Roundtable: Inflation Targeting, Dinar Appreciation and External Imbalance: 2006 and Prospects For 2007*, Scientific Association of Economists and FREN,

Figure 4
Real and nominal foreign exchange rate 2000–2008 (growth=appreciation)



HIGH REAL AND HIDDEN UNEMPLOYMENT AND WAGES

25. Although both GDP and industrial production are still far from the “golden” 1989, wages reached that level in 2007. With the help of abundant initial foreign grants as well as by the already mentioned policy of the dinar appreciation and subsidizing domestic aggregate demand, shortly after the start of the transition in Serbia the population became able to finance the minimal consumer basket with one average wage. In the entire period, **the wages increased quickly in real terms, quadrupling in the period of seven years.**

26. With such a rapid increase in real wages, an inevitable **trade-off emerged between wage rises and absence in new employment.** However, the number of unemployed decreased partly due to better record keeping of the real number of employees. The official data (RSO and National Employment Service) show that there are 2,488.8 thousand employed persons and about 795 thousand unemployed. At the same time, the number of employed decreased slightly and the decrease is primarily recorded in the tradables sector, while the increase is recorded in the service sector (commerce, financial intermediation, real property business, education and culture and health and social work). In trade, an increase in the number of employed persons was realized despite a slight deceleration of economic activity.

Table 8
Population of 15 years of age and over

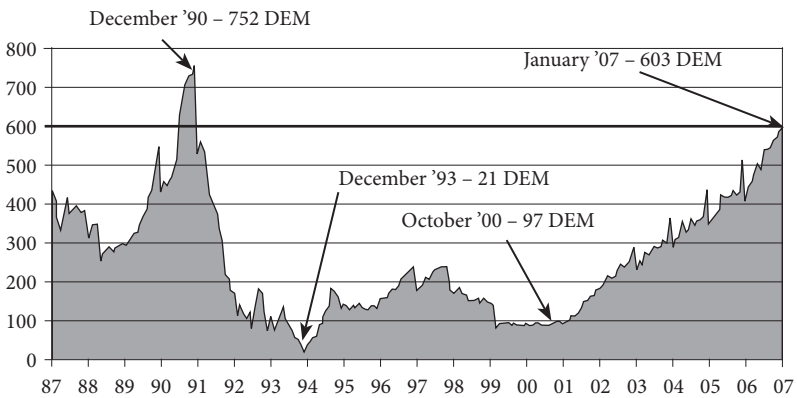
Republic of Serbia	2000	2001	2002	2003	2004	2005	2006	2007
Unemployment rate – total	12.09	12.23	13.28	14.63	18.50	20.8	20.9	18.1
Unemployment rate (15–64 years of age)	13.26	13.36	14.47	16.00	19.53	21.83	21.56	18.8

Source: Labor force survey, Press Release no. 29 from 2008, RSO

The growth deceleration in employment and growth acceleration in vacant jobs indicate a gap between the number of vacant jobs and the number of new employment contracts. At the same time, a deceleration of the growth rate of employment termination was recorded.

27. In addition to hindering the increase in new employment, the high wage increase significantly diverts investments to the nontradables sector and therefore presents a source of high vulnerability of the Serbian economy in the medium term. The golden rule for is that the productivity increase must cover the real wage increase as well as the currency appreciation, which regularly fails to happen in Serbia (compare Fren QM11). Therefore, the policy of financing the balance of payments deficit and filling the budget with privatization proceeds, coupled with further generous rises in wages and consequential crowding out investments from the tradables sector may indeed be called a policy of “selling the family silver”, which has never led to a creation of a sound and competitive economic environment, so there is no reason to believe that it could even happen at all.

Figure 5
Wages in Serbia 1987–2007.



ECONOMIC ACTIVITY

28. **Serbian economy has been recording positive growth rates in the entire period of transition.** There are two reasons for which in the first four years Serbia did not experience the so-called transition recession, which was experienced twice by some countries (Bulgaria, Romania, the Czech Republic etc). The first reason lies in the drastic decrease in economic activity throughout the entire decade preceding the start, which already led to the closing of many unprofitable companies. However, the second, decisive reason for avoiding transition recession lies in the active subsidizing of state-owned and socially-owned companies. Owing to numerous structural reforms, the restructured banking sector, well selected privatization model and increasingly fast arrival of foreign investments, the rates of growth are high. Owing to these reforms the corporate sector started to record aggregate profit.

29. **The population's standard of living in the observed eight years of transition has improved significantly,** GDP *per capita* increased from about USD 1000 to over USD 5600, not only owing to the weakening dollar. The Serbian economic policy seems to have adjusted the entire set of measures precisely to populist goals: (i) the overvalued exchange rate enabled higher imports of consumer goods and a higher standard of living, (ii) high public spending, which enabled to a great extent the wage increase to exceed by far the increase in labor productivity and (iii) delay in implementation of bankruptcy legislation enabled a number of unproductive jobs, at which unearned wages are received, to be kept.

Figure 6
GDP Growth Rate

2007*	7,5%
2006	5,8%
2005	6,2%
2004	8,4%
2003	2,5%
2004	4,2%

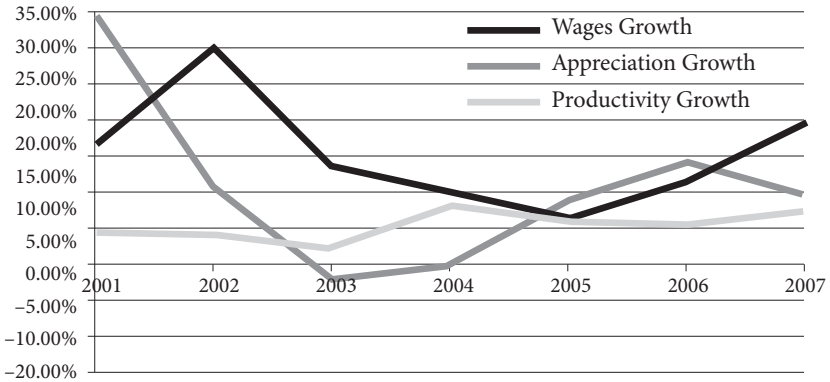
GDP *per capita* in \$

2007	5641
2006	4207
2005	3526
2004	3285
2003	2720
2004	2112

*) Estimation

Source: Statistical Office of the Republic of Serbia

Figure 7
Wages, productivity and dinar appreciation, 2001–2007



30. In such conditions and primarily owing to the significant rise in wages and pensions as well as social transfers, **poverty in Serbia was halved** in the period from 2002 to 2007. According to the data of the 2007 Survey of the Standard of Living, 6.6% of citizens in Serbia, or approximately 490 thousand, are poor. Perceived poverty decreased as well, in particularly among those who estimate their financial position as very poor (the share decreased from 23.5% in 2002 to 15.4% in 2007). The poverty structure did not change substantially, so also today the poorest are the uneducated population and unemployed persons as well as the elderly and multimember households. Regional differences and rural-urban differences are very pronounced and do not decrease. Still the most vulnerable is the population of the rural area of Southeast Serbia (RSO, World Bank, *DIFID Standard of Living Study Serbia 2002–2007*)

31. Due to political turbulence, **the economic reforms were practically halted in the 2006–07 period**, while the state-owned and social-ly-owned companies still drain domestic savings and investments remain very low. In spite of that, the economy of Serbia recorded a very high GDP growth in 2007 (about 7.5%). In addition, this growth coincided with a fall in agricultural production. This increase was primarily realized due to the rapidly increasing aggregate demand stimulated by strong credit expansion as well as pre-election fiscal expansion from the last quarter of 2006. Onse these expenditures for the National Investment Plan were included in the budget, it became obvious how expansionist the fiscal policy really was. With the absence of a serious fiscal reform, such an increase certainly may not be sustainable in a longer term.

32. Conclusion. **Macroeconomic imbalances in the economy of Serbia threaten to hinder further accelerated economic growth.** For the purpose of lessening the key vulnerabilities, it is therefore necessary to: (1) reduce public spending, especially current expenditure, which would make room for an increase in capital expenditure at the expense of subsidies and wage increases in the state sector, (2) privatize public companies and, wherever possible, stimulate new entries in order for the party-based management structure of these companies to be replaced with private owners, and for the competition to enable an increase in the quality of their products and services along with a price decrease, (3) continue attracting foreign direct investments to the tradables sector, primarily by controlling wages in the state-owned sector, by avoiding any further appreciation of the dinar and by continuing the reforms that will increase the competitiveness of the economic environment in Serbia. In addition to reducing public spending, most of the conditions that should be met for the maintenance of macroeconomic stability are clearly in the area of microeconomy and reform of government administration.

Real Sector

PRIVATIZATION OF SOCIALLY-OWNED COMPANIES

1. In the 2001–2007 period, , 1,632 companies were sold by tender and auction privatization, and a total of EUR 2.1 billion of proceeds were realized. In addition, EUR 1.2 billion of additional investments have been secured and EUR 276.7 million for social program. In 2007, 299 companies were sold, for a total of EUR 481.8 million and EUR 134.2 million were provided for investments. Most of the privatized companies (112 or 49%) were from the manufacturing industry sector, whose sale brought 39.3% of proceeds and 54.7% of investments in 2007.

2. In the 2002–2007 period, from the Share Fund portfolio, about 1.220 blocks of shares were sold and proceeds of EUR 613 million were realized. In 2007, the **Share Fund** sold minority blocks of shares of 420 companies and realized privatization proceeds of EUR 162.8 million. Minority blocks of shares of 348 companies were sold for the first time in the capital market.

3. Due to the privatization and new entries, there was a relatively significant change in the employment structure:

4. It may be seen from the table that there was an increase in employment in the private sector by about 300 thousand people, with a decrease in employment in the non-private (socially-owned and state-owned) sector by about 750,000 people.

5. The conduct of privatization so far may be characterized as relatively good, with no major scandals. The scandals that did occur in the previous period were mostly related to the enforcement of the old Privatization Law or to the bankruptcy procedure.

6. The concept of privatization that was based on the sale of majority of shares of companies to strategic investors, with distribution of a smaller number of shares to the employees and with a mandatory

Table 1
Крегање емплојмент

	2001	2002	2003	2004	2005	2006	2007
Total number of employees	3,105,598	3,000,220	2,918,589	2,930,846	2,733,412	2,630,691	2,655,736
In private sector (including agriculture)	1,430,430	1,427,126	1,540,489	1,667,767	1,640,139	1,632,617	1,730,861
In non-private sector	1,675,678	1,573,064	1,378,100	1,263,079	1,093,273	998,074	924,875
In private sector (including agriculture) %	46.1%	47.6%	52.8%	56.9%	60.0%	62.1%	65.2%
In non-private sector %	54.0%	52.4%	47.2%	43.1%	40.0%	37.9%	34.8%

Source: Labor force surveys, RSO

competitive method of sale proved to be very good. However, one of the shortcomings of the adopted model became apparent in Serbia as well – the model is very slow and demanding in administrative terms. Thus the deadline for privatization completion has been extended to the end of 2008. Such delay was also caused by the strategy of selling the best companies first and leaving the worst, the ones on the verge of bankruptcy, for the end.

RESTRUCTURING

7. In parallel with the decision on the privatization model, a strategic decision was also made to leave the restructuring of the real sector mostly to private owners after the privatization. However, in a limited number of cases (about 80 companies) decision was made that the state should perform the pre-privatization restructuring. The mentioned restructuring, if a suitable solution is found for the companies' debts, may perhaps be called a substitute for bankruptcy or for liquidation of the companies through bankruptcy.

8. The pre-privatization restructuring process may hardly be rated as good. Although it is evident that it is a very large economic and even political problem, one gets the impression that the entire process was conducted relatively poorly. In contrast to that, the post-privatization restructuring, the one conducted by new, private owners, led to favorable results in a great majority of cases, although it was inevitably accompanied by workforce layoffs or reduction of employment to the sustainable level. Today, such companies, together with green field foreign direct investments, are the drivers of the economic growth and exports of Serbia.

9. It is certain that three main technical problems have arisen relating to carrying out the pre-privatization restructuring. The first is the problem of identification, separation and verification of the claims that various creditors have against the mentioned companies, since their due obligations have not been settled for years and even decades. That problem is intensified by the problem of debt towards the state for the write-off of which, whether conditional or unconditional, independently of the government policy, there were no legal grounds in certain situations. The second problem is the relatively complex and rather senseless organizational structure of these companies, primarily the cases of socially-owned holding company created by a transformation of the so-called composite organizations of associated labor. This second problem was compounded by the engagement of foreign consultants, which was mandatory in some cases, where grants of large multilateral donors were used. The foreign consultants, unused to such organizational solutions, wasted time searching for sense

where there is none nor has there ever been. The third problem was the debt of those companies towards the government, which led to the negative value of capital and rendered privatization after restructuring impossible. As late as in mid-2005, legal grounds were created for a “release” of debts i.e. for payment to the state-owned creditors from privatization proceeds, which accelerated the restructuring and privatization of these companies.

10. However, the key reason for the absence of activity in the sphere of pre-privatization restructuring of this group of companies lies in the lack of political will to do it. The surplus labor in these companies presents the basic reason for the lack of that will. Namely, restructuring of those companies would inevitably lead to a layoff of a large number of current employees, whether directly, during the pre-privatization restructuring, or indirectly, after the privatization, as part of the new owner’s effort to restructure its own company and increase its economic efficiency. The total number of those that will lose their jobs in the restructured companies varies from one company to another, but it may generally be said that they are older employees, those having lower skills and relatively low capacities to learn and change their working habits and for whom, because of that, it would be relatively hard to find a new employment.

BUSINESS ENVIRONMENT

11. In addition to the activities on the privatization of the socially-owned sector, in the past eight years the Government also put a lot of effort into the **improvement of general business environment**, with the basic aim of attracting foreign direct investments but also with the aim of establishing new domestic companies, which were expected to employ all of those left jobless. In 2006, Serbia was even declared a leader in reforms. Unfortunately, the pace of reforms decreased in the following years.

In that regard, it is worth reviewing the findings of the “Doing Business” report regularly published by the World Bank, in which the countries of the world are ranked according to various indicators (Table 2).

12. It may be concluded that by far the greatest progress was achieved in obtaining loans and financing business activities. Serbia is ranked very poorly in the areas of judiciary (contract enforcement) and bureaucracy (obtaining permits, property registration), and the labor legislation is also very inflexible.

Table 2
Business environment

Category	“Doing Business” ranking for Serbia in 2008
General ease of doing business index	86
Starting a business	90
Dealing with licenses	149
Employing workers	110
Registering property	115
Getting credit	13
Protecting workers	64
Paying taxes	121
Trading across borders	58
Enforcing contracts	101
Closing a business	103

CHALLENGES AND DILEMMAS

13. The biggest problem related to the completion of privatization in Serbia is the fate of the companies that are still in the restructuring procedure. The key issue is the lack of political will to complete the privatization, but one gets the impression that, even if the political will existed, the process of bankruptcy of these companies could last long. Namely, the administrative capacity for carrying out complex bankruptcies in Serbia still does not exist, although significant progress was made with the passing of the new Bankruptcy Law and initiation of licensing of bankruptcy administrators.

14. Also, in recent months it may be noticed that the government is inclined to consider alternative methods of privatization as well, such as the one planned for the Zastava Automobili company. Although a *joint venture* with a strategic investor may be a good option in a very limited number of cases, it should not be applied as a substitute for bankruptcy of collapsed firms or tender sale.

15. One of the most valuable resources that is not privatized in Serbia and will probably be privatized in a relatively near future is **urban land**. The new Constitution, passed in 2006, enables private ownership over urban land, while the privatization procedure has not been defined yet.

Several dilemmas appear regarding this issue. The basic issue is the connection between privatization and restitution. The existing Draft Denationalization Law provides for land restitution in kind to previous owners while keeping the current owner's ownership over the real property but not over the land. Such a solution is inadequate and may lead to big problems in the future. One gets the impression that, when it comes to urban land, financial compensation would be a better solution.

16. Privatization of public companies is another big issue, but we mostly deal with it in the section on infrastructure. If we confine ourselves to the public companies that are not involved in infrastructure and utility areas, we may identify several types of companies. The first type is represented by the public companies managing natural resources (the Srbijašume Forest Management Company and the Srbijavode Water Management Company, before all). The second type consists of the economic entities organized as public companies but essentially performing functions of government authorities, such as the public companies for urban planning or so-called urban development agencies. Regarding these companies, several options are possible. The first option is to reintegrate part of these companies in the government administration again, particularly those company parts essentially engaged in making regulations and to delegate parts of their activities to private companies wherever possible. The second option is for them to remain in the current public company regime.

17. As regards the business environment, the first and largest problem is related to acquiring land and obtaining construction/development permits and licenses. The basic issue is urban land privatization, which has already been discussed. The second problem is the urban planning regime, which has not undergone sufficient reforms. Although the Law on Planning and Construction, passed in 2003, improved the situation to some extent, it is still rather poor. The manner of planning to service the land with utilities and its financing should be changed as well. The present system places the entire burden on the investor (which is good), but does not guarantee in any way that he would get what he paid for. It is also worth mentioning that, at the initiative of the international community, environmental laws have been passed, which made obtaining the necessary construction permits considerably more difficult, particularly for manufacturing facilities. A special problem, based on the World Bank analysis, is a relatively poor situation regarding the flexibility of the Serbian labor market. The situation in this area deteriorated compared to the period 4–5 years ago, after the passing of the new Labor Law. With the formation of the new government, which, however formed, will insist on “social justice”, it is hard to expect significant progress in this area. Finally, a significant barrier to business is the unreformed and inefficient judiciary and low efficiency in terms of contract enforcement.

Financial Sector

BANKING

1. The banking system of Serbia, after the radical structural changes, is recovering rapidly. The credit supply increases, interest rates decrease, although the interest margins are still relatively high. In late 2007 a total of 35 banks operated in Serbia with a total of 2,435 operational units (branches, sub-branches, counters as well as agencies and exchange offices) and a total of 30,246 employees. The sector ownership structure is currently the following: the majority owners of 21 banks are foreign shareholders, the majority owners of 6 banks are domestic natural and legal entities and the majority owner of 8 banks is the state. Five banks with the highest total assets at the end of 2007 account for 45.9% of the total assets of the banking sector. The HH index of total asset concentration is 606 and exhibits an upward trend. The banks with foreign entities as majority owners account for 75.5% of the total assets, the banks with the state as majority owner account for 15.7% and the banks with predominantly private domestic ownership account for 8.8%.

2. **The increase of credit supply has been high** during the entire period and has exhibited an accelerating trend during the last three years. For that reason, the Central Bank was forced to decelerate the bank credit activity, particularly towards the retail sector. The increase in loans for 2007 was RSD 215.4 billion or 39.5%. Corporate loans are still predominant (57.5% of the total loans). Retail loans, from nearly a zero share in 2001, reached 39.8% of the total loans in late 2007. During 2007, the total absolute increase in corporate loans (RSD 114.4 billion) became almost equal to the absolute increase in retail loans (RSD 106.7 billion). Therefore, the credit activity towards this sector was the most dynamic form of bank activity during the previous years. Admittedly, the balance sheet amounts of loans to companies underestimate their real level, because during the last two years a part of these loans were realized as the so-called cross-border loans that are not recorded in the balance sheet but as the off-balance sheet items.

Table 1. Dynamics and structures of basic loan types (in millions of dinars)

Sector	31. 12. 2005		31. 12. 2006		31. 12. 2007		Growth rate in 2007.	Growth rate in 2006.
	amount	in %	amount	in %	amount	in %		
ECONOMY	281,855	64.8	322,972	59.2	437,387	57.5	135	115
HOUSEHOLDS	124,651	28.7	195,873	35.9	302,543	39.8	155	157
for housing construction	23,289	5.4	47,334	8.7	89,434	11.8	189	203
PUBLIC SECTOR	23,812	5.5	21,644	4.0	13,928	1.8	64	91
TOTAL	434,527	100.0	545,481	100.0	760,905	100.0	139	125

Source: National Bank of Serbia, Bank Operations Inspection Activities, Q4 2007 Report.

Table 2 Sector structure and dynamics of deposits, in millions of dinars

	31. 12. 2005			31. 12. 2006			31. 12. 2007			Growth rate in 2007	Growth rate in 2006.
	dinars	foreign currency	total	dinars	foreign currency	total	dinars	foreign currency	total		
Total	142,211	342,472	484,683	227,382	438,908	666,290	343,997	616,164	960,161	144	137
Companies	65,934	53,928	119,862	105,344	72,489	177,833	185,090	105,610	290,700	163	148
Public sector	14,082	946	15,028	21,103	723	21,826	26,552	883	27,435	126	145
Foreign persons	1,578	16,334	17,912	2,736	19,639	22,375	6,427	24,580	31,007	139	125
Households	22,268	190,025	212,293	33,523	260,746	294,269	46,781	381,439	428,220	146	139

Source: National Bank of Serbia, Bank Operations Inspection Activities, Q4 2007 Report.

3. **The total deposits in the banking sector increased rapidly as well.** During the last two years, the predominance of foreign currency deposits in the total deposits has been decreasing gradually, and now they account for 64.2% of the total deposits. The maturity structure of deposits is still dominated by short-term deposits (53.3%) and demand deposits (42.0%). In the initial phase of recovery, the maturity structure of domestic savings was of a noticeably low quality, with the demand deposit share at the level of about 70%. This problem has been solved in two basic ways during the last three years: by importing foreign savings and by increasing interest rates on longer-term deposits. The first solution, which was predominant during 2005 and 2006 was discouraged by high required reserves on these types of sources. The second solution was used by banks, especially those that are not parts of large European bank holdings, during 2007.

4. Increasing the size (of total assets) remains the first goal of the economic policy. This goal is achievable in the medium term because the banking sector of Serbia still has high growth potential. And this means that the present model of regulation should not be changed in conceptual terms but developed further. In order to maintain the dynamics of the banking sector recovery it is necessary to maintain a high dynamics of savings increase. The monetary stability remains the primary condition for achieving this goal, but also for further improvement of competition in the deposit market. The second condition is an increase in the level of quality (maturity structure) and utilization of domestic savings. The central bank may, if the goals of sustaining the monetary stability allow it, gradually reduce the rate of required reserve on domestic savings.

5. The second basic strategic goal is an increase in the banking sector efficiency and reduction of financial intermediation costs. The intermediation costs (net interest margin) of banks in Serbia are still high. Competition increase in the banking sector is possible by a) developing regulatory framework for micro-financing and b) regulatory framework for mutual financing (savings banks, savings-loan cooperatives).

6. It is desirable to **formulate very soon a strategy of continuation of banking sector privatization**, which should define in which banks the state will keep its ownership and in which not. A desirable solution is the privatization of small banks as quickly as possible and keeping of state ownership in one or two banks. Another important issue is the privatization method. It is desirable to explore the possibility of applying the public offer (IPO) model in one of the two large state-owned banks. It is also desirable to solve in a short time the problem of managing the assets of banks in bankruptcy and to focus the activity of the Deposit Insurance Agency on the basic area of deposit protection.

6. Increasing the safety level of the banking and financial system and reducing the level of its risk should enable its easier integration into the European processes and reduce the transfer costs. The supervision over operation of banks and other financial institutions should be further modernized in institutional and technical terms. The new secondary legislation, which comes into effect as of 1 July this year, fully implement the Basel I standards. The next step is the preparation and implementation of the Basel II standards. It is desirable for the central bank to prepare and publish, as soon as the conditions are created for this, a plan of implementation of the Basel II standards.

7. Taking into account the extent of interconnection of banks, insurance companies and brokers, the experiences of some EU countries that have a single institution for the supervision over all financial activities should be considered.

FINANCIAL MARKETS

8. **The basic assets** traded in the financial market of Serbia during the last six years are mostly the **shares issued in the privatization procedure under the 1997 Law** and, to a lesser extent, the bonds of the Republic of Serbia issued for the purpose of settling foreign currency savings deposits. The total, especially liquid, market capitalization fluctuated wildly. During the last three years, the trends of ownership concentration and market emptying on the supply side have been observed. The number of shares traded decreased due to the concentration and withdrawal of blue-chip shares from the trading. The growing demand was concentrated on a relatively small number of securities. During 2006 and 2007, an upward trend was observed in the volume of trading, especially in the continuous trading segment. This process was a consequence of the entry, on the demand side, of a large number of individual investors and activation of additional sources of institutional demand (investment and pension funds). The process of market emptying decelerated, but did not stop. The two formal listings of the Belgrade Stock Exchange (A and B) were empty for years. Currently, three shares are on Listing A, while Listing B is empty. All other shares traded on the Stock Exchange are listed on the so-called free stock exchange market. Shares of as few as some one hundred companies are actively traded, while there was no trading in shares of about 1.200 listed companies in the observed period. The free stock exchange market is regulated by the Stock Exchange internal rules and observed in strictly formal and legal terms, the companies on that market are not public joint stock companies.

9. Since its origination until today, the financial market has predominantly been a **mechanism of ownership right redistribution and to a lesser or almost negligible extent a mechanism of financing the corporate sector and public sector**. The basic (strategic) goal of financial market development is its preparation for that basic function. It is possible to do this with a fundamental reform of the regulatory framework that would enable the issuance of securities of corporate and public sector. Within this reform, it is necessary to a) revise the basic laws on securities (IPO procedure, authority of the regulatory body, protection of investors and market integrity), b) harmonize them with the legislation on economic associations (company opening and closing, public offer of securities) and c) improve the secondary regulations and efficiency of the regulatory body (procedure of protection against price manipulation, budget and tariffs).

10. In addition to the Law on the Market of Securities and Other Financial Instruments, which is partly harmonized with some EU directives, **it is necessary to reconstruct radically the Takeover Law**, which, in its current version, practically suspends competition in the takeover market. The basic direction of the law revision should be harmonization with the EU standards. Significant issues that present an integral part of the regulation of this area in the EU are not covered by this law or are insufficiently regulated (public offer announcement, binding public offer, competitive public offer). Some solutions are vague so their application is almost rendered impossible (competitive public offer, supervision). Some these solutions are included in the existing draft amendments to the Securities Law, which were prepared by the Ministry of Finance.

11. In parallel with risk reduction, which would be achieved through a revision of basic laws, a reduction of expenses accompanying the issuance of new instruments is possible in a short time. These fiscal and regulatory expenses (fees of the Securities Commission, the Central Registry and other related institutions) increase the expenses of issuing securities from both the corporate and the public sector. Along with new regulations, these measures should encourage the issuance of new securities, which would lead to the expansion and deepening of the market. Otherwise, the activation of new sources of demand in the financial market from the sector of investment and pension funds could lead to an appearance of an accelerated increase and an equally fast decrease in the value of indices, such as the one registered during 2007.

12. In addition to a revision of basic laws, a special law on mortgage securities or on securitization is necessary as well. Issuance of low-risk mortgage-based securities would be enabled by this law.

13. Strengthening the regulatory and supervisory function in the financial markets may also be considered a strategically important goal. It is necessary to redefine the authority of the regulatory body and increase its real capacity of regulation and supervision by defining its status as a clearly and practically independent regulatory body, from the Government as well as from market participants. It is possible to achieve these goals either by strengthening the existing institution (the Securities Commission) or by forming a new institution for supervision over all financial activities (banking, insurance, funds, financial market (integrated supervision concept), while taking into account the experiences of other countries. An important goal is also the strengthening of the self-regulatory bodies and professional associations that enable an increase in the market discipline and improvement of ethical standards of professions, increase in the level of professional knowledge and skills and creation of confidence of the investment community and general public in the institutions.

INSURANCE

14. **The insurance activity is underdeveloped** compared to most European countries. Such an estimate refers particularly to the life insurance area. The premium *per capita* (so-called insurance density) is close to the European minimum. The insurance sector restructuring started in June 2004 with the implementation of the new legal authority of the NBS in this activity (the functions of supervision, normative regulation of business operations, issuance of business licenses and other forms of supervision). Separation of life and non-life insurance activities, as well as a strict separation of insurance from reinsurance were made by legal regulations. Also, the cash capital threshold by insurance type was increased significantly and free entry of foreign investors was enabled. Since June 2004, the number of insurance companies has been halved, while the number of reinsurance companies has remained the same. Two insurance companies dominate the insurance market. The majority share of one of them is socially-owned. The other companies are privately-owned.

15. The regulatory reform essentially normalized the property insurance as a traditional form of insurance in Serbia. The remaining activities in this area involve the regulation of the area of TPL and secondary regulations relating to the implementation of basic legislation: the Insurance Law, the Law amending the Law on the National Bank of Serbia, the Law on Bankruptcy and Liquidation of Banks and Insurance Companies and other relevant legal regulations. Particularly urgent are the problems related to the obligations of insurance companies in which bankruptcy proceedings have been initiated and the problem of the guarantee fund.

16. The inherited duopolistic market structure will be maintained in the circumstances when the second largest insurance company has been privatized. Because of that, it is important to define, in a short time, a strategy of privatizing the first insurance company. The process of restructuring this company is under way and the selection of privatization method to be applied depends on its results. If there is a high probability that the company value will increase, it is desirable to apply the initial public offer (IPO) method. However, if it turns out that the company's value will decrease, the solution of one-time privatization by public tender method is recommendable.

17. Enforcement of the Decision on the Manner of Protecting the Rights and Interests of Policy Holders, Insurance Beneficiaries and Third Parties has a special importance for gaining confidence and for the development of domestic insurance.

18. Stimulating fiscal policy measures in the area of personal income taxation that may accelerate the development of voluntary pension insurance are desirable. In addition to tax incentives, it is desirable also to create other incentives for the development of life insurance services.

19. Depending on the basic strategy of further development of supervision, a strategy of insurance supervision should be formulated as well. If the solution of integrated supervision is not accepted, it is desirable to form a separate insurance regulatory body within the National Bank of Serbia. If the idea of integrated supervision is accepted, a process should be initiated of gradual unification and integration of insurance supervision into a single institution for the supervision of the non-banking financial sector and then the financial sector as a whole within the NBS.

Agriculture

1. In Serbia, agriculture is not considered an ordinary industry, primarily due to the specific character of this production, as well as due to the tradition and great expectations associated with it. In all municipal and regional strategies, agriculture is recognized as one of the basic strategic directions of development, and a large part of the population, rural as well as urban, sees the greatest developmental opportunity of Serbia in it. Agriculture is indeed an industry that may produce more wealth than it does now and thus contribute to the development of the country. It may also present a short-term buffer for facilitating transition processes, but it may not continue to employ the number of people currently employed in it and be competitive in the region Serbia strives to join through integration processes. The conflict of the role of agriculture in the economic development and its social component is what characterized the past period. Changes in the agriculture are happening, albeit slowly, and rather as a response to the market processes and not as a clear Government strategy for sector development, while the institutional and legislative reforms have been initiated but not completed. Several clear characteristics and trends may be observed in the previous eight years:

2. Change in ownership structure and land consolidation. Although the privatization of the whole sector is not complete, because a certain number of agro-industrial complexes have not been privatized yet and most of the “old cooperatives” do not have a resolved status but still operate according to the principles of socially-owned capital in which the employees manage the cooperative, it may be said that this process is nevertheless being brought to an end. It was determined by the Law on Agricultural Land that privatization of the state-owned land should wait for restitution and that, in the meantime, the land should be leased through auction to the highest bidder. Unlike previously, this time the lessee pays a rent, and a novelty is that the lessee may be a natural person as well. Also, the Law left to the municipalities to prepare a program of use of state-owned land as well as to organize auctions. Unfortunately, in many cases the municipalities had neither the capacity nor the will to implement the legal solution, nor did the Ministry of Agriculture, as the institution in charge of the management of state-owned land, observe the Law regarding the assumption of a more active role in cases when

the municipalities fail to observe the Law. Nevertheless, the implementation of the Privatization Law and the Law on Agricultural Land, although accompanied by big problems, has now led to a situation that a large part of the land and resources is used by private producers that are capable of making larger profit.

3. Instability of agrarian policy. Three phases may be identified in the agrarian policy in the past eight years. The first (2001–2003), oriented towards price support for certain crops (soybean, sunflower, sugar beet, wheat) and absence of other agricultural policy measures, the second (2004–2006), in which price supports were abolished and there was a shift to support of investments and rural development, and the third (2007–2008), characterized by the establishment of payment per area and head of cattle and adoption of numerous *ad hoc* non-market measures. Such unpredictability of the policy reduced the possibility of long-term planning that resulted in an investment decrease in the sector and non-market transfer of profit between the participants in the market chain.

4. Slow adjustment to food safety standards. Failure to adopt the Food Safety Law and a number of accompanying laws as well as a failure to establish efficient institutions for their enforcement is one of the greatest failures of the agriculture policy makers in the previous period. The expensive and inefficient system is maintained because of the lack of readiness of the governmental institutions for reform in this sector, which presents one of the most significant problems in the integration into the EU and the WTO and may decelerate these processes to a large extent.

5. Slow development of support institutions and legislative framework. The Republic Commodity Reserves Directorate has not yet been reformed and the Advisory Service and water management organizations still operate as socially-owned companies. Also, the unestablished National Laboratory as well as the unimplemented reform of scientific institutions for agriculture support are some of the unfinished tasks in establishing the institutional framework for agriculture development. Also, cooperative unions, the Chamber of Commerce and professional organizations present big obstacles to reforms in the sector. On the other hand, several significant institutions were established in this period, such as: administrations for veterinary medicine, plant protection, water management and forest management, farm registry and the Secretariat of Agriculture of the Province of Vojvodina. Also, several important laws have been adopted, such as the Law on Agricultural Land, Law on Forest Management and Law on Plant Protection, which provided the basis for the implementation of reforms.

6. Initiated development of loan market and land market. Successful agricultural sector is unimaginable without a developed credit market and land market. The reform of the banking sector, establishment of the registry of farmers with an obligation to open bank accounts, the Ministry's measures for promoting the credit market development and similar contributed to a decrease in specific risks related to farmer lending. Owing to this, the banks are increasingly willing to lend to farmers, which opens a possibility for the development of the land market, lease market as well as the sales market. Trade through barter arrangements in which the interest is presented in a very nontransparent manner have decreased as well.

7. Decrease in the agriculture share in GDP. The constant trend of decrease in the agriculture share in GDP is not caused by a decrease in the value of agricultural production (VAP) but by the development of other sectors. Thus in 2001 the total VAP was RSD 135.08 billion (in constant prices of 2002) which accounted for 15.7% share in GDP, while in 2006 a VAP of RSD 137.8 billion was recorded, which accounted for 10.7% of GDP.

8. Significant increase in the exports value. The opening of the EU market for agricultural-food products from Serbia (Autonomous Trade Preferences from 2000) but also the whole networks of bilateral trade agreements with the neighboring countries (now enshrined in the CEFTA Agreement) created conditions for a transformation of Serbia into a net food exporter. It became this for the first time in 2005, with a surplus of about USD 255 million. High domestic protection, reestablishment of severed trade connections, exports subsidies, but also numerous comparative advantages, lead to a further increase in the foreign trade deficit in this area, which was over USD 600 million in 2007.

9. Gradual market opening. Despite the liberalization in 2001, the agriculture of Serbia still has the highest tariff protection in the region (the average tariff equivalent is about 21%). By negotiations within the WTO and the SAA, this level of protection will be reduced in phases (the SAA within 6 years to the level of 3.1% of the average tariff equivalent). However, almost a whole decade with a high protection, which is primarily a result of active lobbying, has made it impossible to perceive fully the competitiveness levels of domestic products.

10. Undeveloped modern market chains operating in legal area. There are two basic challenges in establishing market chains. The first challenge is – how to include small producers in a modern market chain because they are uncompetitive to a large extent, they operate through informal channels and their cost of complying with standards is high. The second – how to increase the competitiveness at the level of manufacturing capacities that will be able to increase spending

through finding new markets. A high competition at the level of primary production and a low level of competition at the level of manufacturing are obvious, which is primarily caused by low attractiveness of the area for investment due to non-compliance with the EU exports standards for a large group of products, by unpredictability of the support policy, underdevelopment of institutions, absence of knowledge of real competitiveness due to high tariff protection and similar.

11. The agriculture policy makers face numerous challenges that should be solved. The restructuring may be delayed. However, the longer the delay, the lower the foreign investments, and a higher economic cost of resisting is unavoidable. The most important activities that should be undertaken may be classified into several groups:

12. Completion of transition processes of social ownership to private or state ownership. Completion of privatization of socially-owned capital in the agriculture and passing the Law on Agricultural Cooperatives, which is expected to solve the issue of property and management of “old cooperatives”, will enable the allocation of resources to those that will be interested in investing in the improvement of agricultural production. At the same time, it is necessary to return the agricultural land, as one of the greatest resources owned by the state, to its owners through the restitution process, and allocate the remaining state-owned land to those who are able to get the highest yield from it. Until the restitution process is completed, the land should be leased by means of auctions to the highest bidders, and in later stages sold by auction while observing the pre-emption rights of lease/sale defined by applicable Law on Agricultural Land (the right of paying the highest bid for: owners of irrigation systems and perennial plants on the auctioned land, owners of bordering plots and registered farmers).

13. Creation of agrarian policy directed towards market development, competitiveness increase and food safety. The key precondition of agriculture improvement must be the implementation of a consistent and predictable agrarian policy defined by adopted strategic documents. By passing the Law on Agriculture and Rural Development the forms of support to agriculture should be further specified, but the beneficiaries of particular measures should be precisely defined as well. The country’s agricultural policy should have as its basic goal the improvement of production competitiveness, food safety and increasing the share of the funds intended for rural development in the agrarian budget. This means that the funds of the agriculture budget should be used for support to investments in equipment as well as in knowledge, and for building the rural infrastructure for the purpose of improving competitiveness but also developing rural areas into environments attractive for living and work. The legislative activity should be directed towards achieving compatibility with the EU’s *acquis communautaire*, the SPS

and TBT agreements within the WTO but also to creating conditions for institutional changes in the domestic agro-economic system for the purpose of its successful integration into the EU (CAP). In that regard, it is necessary to pass as soon as possible the Law on Food Safety, which will ensure, with as low expenses as possible, that the food produced in Serbia will meet the consumer needs in terms of safety and quality.

Liberalization of the closed domestic market will enable the market allocation of land and other resources and thereby improve competitiveness and provide investments. Taking into account the limitation of the domestic market in terms of area and purchasing power, the driver of development should be an increase in demand through an increase in exports, but stimulated by an improvement of competitiveness and by measures in accordance with the WTO principles. In addition to the traditional exported products (fruit, vegetables, sugar...), the potential lies in organic and integral products as well as the products of protected geographical origin, with a condition of previous legal regulation of these productions (although there are laws defining these areas, it is necessary to improve them).

Development of the financial market and rural loan market as well as building of a functional land market (as regards purchase as well as leasing) must be the basis of agriculture development, so it is necessary for the state to address all obstacles on that path (title over land, contract observance, building the agricultural insurance system, building the system of warehouse receipts etc.). Improvement of the existing market information system in agriculture (STIPS), which will provide producers with timely information about prices and trends in the domestic and international market, should enable development of market chains in agriculture. Association of farmers is the best way of protecting common interests on the both sides of the market, so incentives to associations, cooperatives, chambers and other forms of association should be provided by creating a legal framework but also by financial incentives for collective activities. Although the agricultural policy should not be socially but developmentally oriented, it is necessary to recognize the vulnerable groups of farmers who, with their physical abilities or because they work in the areas less suitable for agricultural production, cannot be competitive and enable them, through the agrarian policy measures, to contribute to the rural development.

14. Development of support institutions. It is necessary to accelerate the initiated reform of institutions, because the upcoming challenges of joining the EU and the possibility of using the EU funds intended for rural development require new and/or much more efficient institutions. At the same time, the increasingly high demands for food safety from domestic producers as well as in exports require the institutions that will be able to guarantee that in an efficient manner. Also, the farmers need for their development the institutions that are capable of making, implementing and controlling the policy in an efficient manner. The

primary goal should be the strengthening of capacities of the Ministry of Agriculture, Forestry and Water Management itself, but also separating its certain functions and delegating them to independent bodies (for example, transformation and strengthening of the Department for Agrarian Implementation into an independent Payment Agency for the purpose of receiving the EU funds intended for agriculture and transferring them to the end users). The newly established Agency should also assume the function of the stabilizer of agricultural market from the Commodity Reserves Directorate, which should be reformed in the direction of replenishing the food stockpiles in case of emergency, as well as by introducing transparency in the work. Implementation of the EU-compatible agrarian policy will be facilitated by introducing specific administrative systems (Land Parcel Identification System – LPIS and Integrated Agricultural Control System – IACS). Food safety must be supported by establishing and putting into operation the National Food Control Laboratory.

It is necessary for the agricultural technical service to undergo ownership transformation through the abolishment of the current social ownership and making its management possible to those that will be interested in its development. In the coming period, in addition to its existing functions, it will get several new functions, such as implementation of the system of economic-accounting indicators of agricultural production according to the EU model (Farm Accountancy Data Network), preparation of business plans for IPA funds and similar. Already now the technical service does not meet the existing tasks, and it will not be able to meet new challenges without a serious reform of its functioning.

A special area of work should be the reform of education and scientific institutions in agriculture, with an emphasis on the EU CAP, farm management, modern techniques of food production, manufacturing and sales, market trends in agriculture, “new” aspects of agriculture (rural development, multifunctionality, environment...). However, before that it is necessary to solve the status of the science institutes that are scientific institutes by their legal status and seed production companies by their function. For that reason it is necessary to form one state scientific institute and privatize the others.

Infrastructure

ENERGY

1. Since 2000, **the electric power system** of Serbia has undergone a thorough rehabilitation and revitalization of almost all existing production and transmission facilities. Most of the investments based on which the rehabilitation was conducted were financed by donor funds. Also, there was a radical change in the price policy, so the electricity price was increased several times and a block tariff was introduced, which led to positive effects on electricity demand management. Introduction of regional electricity market was initiated in order to promote the trade between the electric power industries in the area of Southeast Europe.

2. The attained price of electricity is already rather high so the issue of further price policy arises. Namely, although there is still a lag behind the prices in some neighboring countries, if the electric power industry cannot cover its average expenses with such price, then it is obvious that it is a matter of low production efficiency. The new price increase, which is constantly considered in order to cover the average expenses, does not present by any means an incentive for their control or reduction. In that regard, an urgent introduction of economic regulation that is based on incentives (RPI-X type) should be considered, in order to create incentives for the control or reduction of operating expenses of electric power companies.

3. A process of vertical separation of the electric power system was started by forming a separate public company for electricity transmission, while the production and distribution of electricity was allocated to the Elektroprivreda Srbije Public Company, which has eleven subsidiaries within it. The production company includes all production facilities including the coal strip mines that supply the power plants. The mentioned companies still include a large number of non-core activities, so they are characterized by inefficiency in the performance of the core activity and a rather large surplus labor, which affects the average expenses.

4. There are no clear plans for privatization of the electric power system from the aspect of privatization scope (what will be privatized) as well as from the aspect of privatization method and dynamics (how and when it will be privatized) and also an appropriate pre-privatization restructuring. The idea of free distribution of shares of public companies that appeared during last year is not explained nor developed in detail.

5. The rehabilitation of the electric power system led to an increase in its effective capacity, but the increase in demand caused by economic recovery and economic growth during the last decade led to the lack of available capacity. Therefore, a question arises of the need for building new production capacities (in the light of the question: own production or supply from abroad), primarily of the “Kolubara B” power plant, but also the TENT 3 capacities, or a question of the manner of financing such an investment. The answer to this question inevitably has implications on the organizational and management structure of the electric power system. If such an investment were financed by loans that would burden the public company, nothing would change in the existing organization of the electric power system. If a concession were granted, and then this concession were financed by private capital of concessionaries, a horizontal separation of production would thus be *de facto* started and a question would arise of a single (uniform) price of electricity on the threshold of transmission, i.e. the price at which electricity is sold to the electricity transmission company.

6. Underground **coal mines** have been spun off into a separate public company. Taking into account the quality of supplied coal as well as the high expenses of mining it, the imported coal presents a more economic option to the consumers, so it may not be expected that this company will be sustainable such as it is in this moment. It is probable that the only reasonable option is the privatization of this company (the strategy exists, the Government adopted it in 2007). The private owner will be in the position to restructure this industry radically, which probably implies a closure of certain coal mines and an alternative use of their assets.

7. **The oil industry** is still a vertically integrated monopoly (NIS), which combines the production (exploitation of its own deposits) of crude oil, its refining and production of oil products, as well as the distribution network and retail sale of oil products. By the Regulation of the Government of Serbia, the importation of oil products has been prohibited ever since 2001, so the whole supply of fuel is based on the crude oil refined in the NIS refineries (the exception are those oil products that cannot be produced in the mentioned refineries for technical reasons). There is no monopoly in the oil retail trade, since there is a

large number of companies (some of them foreign owned) that are involved in this activity, but all of them have to buy the oil products solely from the NIS.

8. The price of oil products is regulated directly by the executive power (the Government of Serbia, or the Ministry of Mining and Energy) on the basis of average price of crude oil. The average price of crude oil is in fact the only variable in forming the price, since all of the other price components are fixed and expressed in a physical unit of measure (barrel or ton) including also the refining expenses and importation expenses. Further, the trade margin is limited and this limitation is specified according to the physical unit of measure. Since all of the mentioned parameters are defined by the Government Regulation, they may be changed by changing the regulation as well, which leads to uncertainty regarding the business conditions for all players in the oil product retail market, while the NIS may rely on the transfer of possible increase in its expenses to consumers by exerting pressure on the Government, which means that it has no incentive for expense control. The increase in the prices of crude oil also raises a question of excise duty policy, or whether the whole increase in the prices of crude oil should be transferred to consumers, although no public discussion has taken place about this so far.

9. In early 2008, a comprehensive intergovernmental agreement was concluded between Serbia and Russia by which NIS, with the existing industry structure, will be sold to the Russian state company Gazpromneft. The selling price was EUR 400 million, while the agreement stipulates that the buyer should invest another EUR 500 million during the following five years. The Agreement conditions were not obtained in a transparent manner, for example through an auction or tender, and it is a framework agreement that does not define all details of this transaction. It may be estimated that this agreement also had a significant foreign policy component relating to Russian support to Serbia regarding Kosovo. The Agreement has not been ratified yet by the National Assembly.

10. Gas supply, except for low-pressure gas distribution that belongs to utility activities, is within the competence of the Srbijagas Public Company. In technical terms, the biggest problem of gas supply is the regularity of supply, which may be solved by completing the construction and putting into operation the gas storage facility Banatski Dvor.

11. Further prospects of the gas supply activity depend on the South Stream project and its implementation. Although the intergovernmental agreement was signed, there are still many uncertainties in this area.

12. **The Energy Agency of the Republic of Serbia** is an independent regulatory body established in 2005 with extensive authority in the whole energy sector (electric power industry, oil industry, gas and district heating). A certain part of that authority (price control, for example) is not exercised because the Government still makes decisions on the price of oil products and the price of electricity. The Government does it on the *ad hoc* basis, taking into account the elements that are not of priority to the energy sector (political elements, macroeconomic stability etc.), so the regulatory risk the companies face in this industry increases significantly. At the same time, it turned out that the risk is not distributed equally and that it may be expected that big public companies will have an opportunity to transfer the regulatory risk to other participants in the market.

TRANSPORT

13. **The road network and road transport**, starting from 2001, has seen great endeavors in the sphere of rehabilitation of the road network, which was heavily damaged by inappropriate maintenance during the 1990s. A certain part of the rehabilitation was financed by grants, but a larger part was financed by international loans.

14. The financing system has been changed several times, and current system is based on the principle that 10% of the excise duty on liquid fuel goes to road maintenance, while the whole amount of the road maintenance tax that is paid upon vehicle registration and that equals the total amount of toll is allocated to this purpose. The funds flow into the public road maintenance company Putevi Srbije, which is responsible for the maintenance, development and management of Class I and Class II roads.

15. The amount of the part of liquid fuel excise duty that should be directed to road industry is a controversial issue, which indeed was the subject of political debates and even conflicts during the previous period. Another open issue is the question whether the financing of road industry should be performed through the “road fund” completely independently of the budget or the transfers should go through the budget. Furthermore, a question may also be asked whether the motorway toll proceeds should be used for the purposes of the whole road network (the existing solution) or whether they should be directed solely to the maintenance of the existing motorways and construction of new ones. Finally, another open question is the one of transparency and efficiency of operation of the Putevi Srbije public company, as well as the process of deciding on priorities regarding the construction, rehabilitation and maintenance of the road network.

16. The Government of Serbia made a decision to engage private capital through the concession for construction of the Horgoš-Požega motorway. It was decided also to give over the sections already constructed (the motorway and the semimotorway) to the future concessionary for operation, which it could operate (charge toll) during the construction of the missing sections. The available results of the traffic frequency research show that a certain number of sections south of Belgrade do not have a traffic frequency that justifies the motorway existence. Numerous weaknesses in the procedure of concession announcement, specification of its conditions and selection of concessionary were observed, and then problems also appeared in the conclusion of the concession agreement. Finally, the concessionary failed to fulfill the contractual obligations in terms of delivering a bank guarantee, so by the Government decision it was not allowed to enter into the transaction and start the road construction. The fate of this concession remains unclear but already the experience so far is sufficient for amending the concession regulations, whose weaknesses led to the mentioned problems in the first place.

17. **The railway transport** in Serbia is performed within the monopoly of the Železnice Srbije Public Company. This company is the largest individual beneficiary of subsidies from the budget of Serbia and in 2007 they were about EUR 120 million. Even with such subsidies, the company records losses due to high unit costs as well as due to insufficient demand for transportation services.

18. A large part of domestic freight transport is now directed to road transport or truck transport including also the transport for own purposes, which is far faster, more efficient and more flexible, especially taking into account the increased demands for quality transport services. Furthermore, observed in geographic terms, Serbia is a small country with a small average length of transport, which certainly does not favor railway transport, so the high share of transit (about 50% measured by ton-kilometers) in the total volume of railway operation is not surprising. Over 50% of the total quantity of transported goods without transit is accounted for by only one user (*USS Serbia*, Smederevo) and it is very likely that, when institutional conditions are created, this operator will be able to form its own company or a company under its own control. Similar arrangements may be expected in the case of transit as well.

19. The passenger railway transport faces high demand elasticity, since the competition by the road transport is extremely high. In the given conditions, it is very likely that the passenger transport may not be expected to be profitable.

20. The first step towards the separation of transport activity from the railway infrastructure was made, but there was a slowdown in the application of this concept, since there is a lack of all those secondary regulations that would enable the real separation and introduction of competition or more operators in the freight transport. The regulatory function in this area is still completely in the hands of the Ministry.

21. **The flag carrier** is organized as a public company and it is still not adjusted to the new situation resulting from the disappearance of the market of former SFRY. Such an adjustment may not be expected before the privatization, which had been postponed for a long time and finally announced for 2008. In the preparation for privatization, the maintenance sector was spun off and it should be privatized in a separate procedure, in all likelihood simultaneously with the airline company.

22. The Belgrade Airport is organized as a public company. It provides services to all interested companies, although the flag carrier enjoys a privileged status in terms of service price and payment terms. It remains unclear whether, when and how it will be privatized.

23. The competent ministry deals with the regulation of the air transport activity and practically has a discretionary right to grant individual transport licenses. The "Open Sky" agreement with the EU was signed but not ratified and has not come into effect.

TELECOMMUNICATIONS

24. In the area of fixed telecommunications there is only one operator. Although there are no legal barriers to the entry of new operators, not all regulations (sub statutory texts) have been prepared that are necessary in order to grant licenses to new operators. The penetration level in fixed telecommunications is just over 30%.

25. In the area of mobile telecommunications there are three operators with the penetration level of just over 72% (when taking into account the subscribers with several subscriber numbers). This penetration level is at the level of the regional average.

26. The Internet penetration level is relatively low (penetration level of 23.4%, while it is as low as 1.6% in the case of broadband Internet).

27. An independent regulatory agency was formed (RATEL), which has a large authority in the sphere of communications and radio communication, but not all secondary regulations have been prepared yet that are necessary for its smooth operation.

28. Telekom Srbije is the only telecommunications company in which there is state ownership (80%). Different ideas appear as to what should be done with the state-owned capital, but it seems that the discussion in this sphere is not linked too much to the future development of telecommunications in the country.

MUNICIPAL INFRASTRUCTURE

29. Municipal infrastructure and local utilities in Serbia are performed by local public utility companies that are controlled by local authorities. These authorities, in addition to the decisive control over operation of public utility companies, also have the authority for their regulation by means of giving approval to each price change. The utility companies are very often fully integrated monopolies that, in addition to their core activities, perform numerous non-core activities as well. The legal provision regarding the contracting-out of certain utility activities is practically not applied.

30. **Water supply**, as the most important utility activity, is characterized by still relatively low selling prices, which in most cases do not enable the covering of operating expenses (including amortization).

31. **Garbage removal** is organized either within separate utility companies or within integrated utility companies providing all utility services except for water supply.

32. **Privatization** of public utility companies has not been considered seriously so far, especially considering the complexity of this operation and diversity of the utility companies existing in the towns of Serbia, as well as a large number of privatizations and PPP models. The question of uniform economic regulation of these activities has not been considered seriously so far, either. The future development of utility activities in Serbia depends on the answer to these questions.

* * *

33. The public policy in the infrastructure in the last eight years has been characterized by a lot of indecisiveness regarding privatization, its scope and procedure, industry structure and economic regulation. While in the first years of the transition most of the attention was directed towards the rehabilitation of the existing infrastructure, which was heavily damaged primarily due to poor maintenance during the previous decade, the completion of the first phase of rehabilitation (largely with the funds of international financial institutions) led to numerous dilemmas relating to institutional reforms in these industries. Discussion still continues about the desirability of keeping

the monopoly in the oil industry, the level of vertical integration of electric power industry and introduction of competition in fixed telephony (telecommunications), regional networking etc.

34. Since most of the infrastructure is still linked to public companies, the data about the largest public companies in Serbia are given in the Table 1.

According to the data of the National Bank of Serbia's Solvency Centre, Press Release on the realized business results of business entities and cooperatives in the Republic of Serbia, the share of public companies in the total fixed assets is 27.7% and 28.6% in the total capital.

Table 1
Basic parameters on public enterprises

	Operating income 2006	Number of employees, 2006	Pre-tax profit margin, 2006	Equity 2006	Return on equity 2006
Oil Industry of Serbia	257,431	13,152	2.8%	93,734	7.6%
Electric Power Industry of Serbia	103,633	34,789	0.1%	308,370	0.0%
Telekom Srbija	62,552	10,639	25.2%	98,777	16.0%
Srbijagas	45,681	1,007	0.3%	10,352	1.3%
Roads of Serbia	21,196	1,105	-20.7%	89,670	-4.9%
Serbian Railways	20,897	21,604	-31.8%	169,425	-3.9%
JAT Airways	13,454	1,930	-9.1%	N/A	N/A
Belgrade Heating Plants	9,294	2,388	-18.0%	9,235	-18.1%
GSP Beograd – Belgrade Public Transport Company	7,851	6,877	-3.2%	12,758	-14.9%
Water Supply and Sewage of Belgrade	6,264	2,970	2.4%	25,383	0.6%
“Nikola Tesla” Airport	3,575	698	16.4%	11,463	5.1%
TOTAL	551,828	97,159	1.8%	829,167	4.7%

Health Care System

1. The basis for the reform of the health care system in Serbia was set in 2002 in the documents Health Care Policy and the Vision of Health Care System Development and then the Strategy and Action Plan of the Health Care System Reform until 2015. The most important system laws were adopted in the mid-2000: The Law on **Medicines and Medical Devices** (2004), Health Care Law, Health Insurance Law and Law on Health Workers' Chambers (December 2006) as well as several sector laws: Law on Protection of the Population from Communicable Diseases and the Sanitary Inspection Law (2004), Law on Drugs Precursors and the Red Cross Law (2005). A certain number of bylaws (rulebooks) are still in the process of making. The Health Council was not set up due to the delay in the constitution of the health workers' chambers that are appointing their representatives to this body. That is why the Health Care Development Plan and Program that the Assembly is supposed to adopt was not passed.

2. In the period 2002–2008 **numerous multi-sector strategies** that affect the health care system development were adopted.¹⁹ Besides those, there are strategic documents that directly determine the health system development such as the National Strategy in the Fight Against HIV/AIDS (2005), Strategy for Youth Development and Health (2006), Tobacco Control Strategy (2007) and Mental Health Development Strategy (2007) and two national programs – Program for Protection of the Population from Communicable Diseases from 2002 to 2010 (2002) and Program for Protection of the Population from Tuberculosis (2005). A few of the strategic documents of the Ministry of Health have been prepared but not adopted: Strategy for Provision of Adequate Quantity of Safe Blood and Blood Products, Public Health Strategy, Safe Food Strategy, National Strategy against Drugs and Alcohol and National Strategy for Prevention and Control of Mass Non-infectious Diseases.

19 Poverty Reduction Strategy (2003), Action Plan for Children (2004), The Roma Action Plan formulated within the Strategy for Integration and Granting New Authority to the Roma (2005), Strategy for the Elderly (2005), Strategy for the Youth (2008) and Strategy for Prevention and Protection of Children against Harassment (2008).

3. So called *preventable and premature mortality* is dominating the death of the citizens of Serbia. According to the data from 2006 the leading causes of death are related to cardiovascular diseases (56.1%) and malignant diseases (21.5%), injuries, poisoning and consequences of external factors' activities (4.4%) and symptoms, signs and pathological clinical and laboratory signs (3.1%) which are all diseases and conditions that could be prevented by timely activity of the health care service and they affect the people in the most productive period of their lives. This kind of mortality structure indicates, among other things, the quality of health service work as well as the attitude of the population towards its own health. Among the *health risk factors*, the most significant individual risk factor is smoking, followed by physical inactivity, insufficient intake of fruit and vegetable, high blood pressure and high cholesterol level in the blood.²⁰ The health survey of the Serbian population including 6,156 households in 2006 indicated the reduction in smoking frequency by 6.9% compared to 2000, increase of physical activity, increase in high blood pressure frequency, increase of alcohol consumption, riskier traffic behavior but also better knowledge of health risks and more frequent monitoring and counseling in the state health institutions regarding the risk of chronic non-infectious diseases.

4. One of the fundamental health policy goals is to have a **patient/beneficiary in the center of the health system**. A person to protect the patient's rights has been appointed at the institution level, the rights and obligations of the patients have been better defined in the new Health Care Law and there were several national campaigns for promotion of these rights ("You are Entitled"); also better communication was established between the health workers and health service beneficiaries ("Health Comes with a Smile"). Recently a "white telephone" has been introduced in the Ministry of Health for questions, complaints and comments of the beneficiaries. The satisfaction of the beneficiaries with the health service work monitored for four years through the national survey has increased, more in the primary than in secondary health care. The health institutions, HIF and the Ministry of Health improved transparency of their work by setting up and regularly updating their websites.

5. The health care system in the state sector is characterized by a **well-developed network of health institutions on the primary health care level** (PHCs, health stations and ambulances), **secondary** health care level (general and special hospitals) and **tertiary** health care level (clinical-hospital centers, clinics and clinical centers). The reform of provision and delivery of health service to the population included, first of all, the reconstruction of health institutions, equipping them with modern equipment,

20 Disease and injury burden in Serbia, 2003.

network rationalization regarding the health institutions and the number of available beds, and then the improvement of the quality and efficiency of the work. At present the working conditions of the health system employees are significantly improved, all the necessary equipment has been purchased, especially the equipment of high technological value (ultra-sound scan, laboratory equipment, angio-halls, scanners, magnetic resonance and other); there is a better definition and division of the institutions according to the health care level; the rationalization of the number of available beds has been executed and there was the introduction of monitoring and ranking of the health institutions according to the results concerning the continual improvement of the health care quality. The so called curative orientation in health service delivery was substituted with health promotion and disease prevention through the establishment of health centers for prevention within the PHCs, development of programs for prevention of risk behavior and early detection of the most common diseases, as well as strengthening of public health. A significant reform was conducted in dentistry by keeping only child and preventive dentistry and emergency interventions within the state sector. The costs of other dental services have been transferred to the citizens.

6. **The private sector** still lags greatly behind in regulation and control. There were some small steps in recognizing the medicines issued on prescription in private practice, the contracting process for diagnostics services for which there are long waiting lists is in progress (scanner and magnetic resonance) as well as therapy services, like IVF. Still there is the important issue of its more complete functional and financial integration into the health system.

7. **Health staff development and planning** was one of the reform priorities. The state health sector had a total of 108,975 employees in 2007 which is by 17.2% less than in 2000. The reduction was achieved by rationalization through the voluntary lay-offs with severance packages for over 14 thousand workers. The consultant hired to analyze the human resources in the health system of Serbia estimated that there was a good provision of all medical profiles to the population and that there was a surplus of doctors of 10% (compared to the work performance) and a 25% surplus of non-medical workers of uneven geographical distribution which cannot be explained by demographic characteristics of the population or their health problems. Moreover, it was pointed out that the professional roles and responsibilities of the employees were rigid, the planning was centralized and based on obsolete norms, and the skills and trainings of health workers did not comply with the changes in the system.

8. The number of unemployed doctors has increased, despite the employment of 200–300 doctors and 700 nurses a year. On the other

hand, due to the “rationalization” process there is a demand for some other medical profiles (radiologists, anesthesiologists, cardio surgeons) as well as medical nurses for providing care in hospitals. There has not been a significant unemployment reduction due to the uncontrolled inflow of all medical profession profiles. According to some estimates, three to four times more people are being educated than the system actually needs. Unless the need for staff is carefully planned on the government level (and *numerus clausus* introduced) and unless there is some change of how the faculties and schools are financed, it will not be possible to solve the current unfavorable situation. The productivity of the people employed in the system does not match the investments so far, i.e. according to the results of the analyses, the increase in the coverage of population by health workers is not accompanied by better performance or more significant health improvement of the population.

9. In the last several years considerable means were invested in various forms of education and training of the health workers, especially in the public health sector (Public Health School Center was opened at the Faculty of Medicine in Belgrade) and the EU has granted funds in the amount of 5 million Euros to establish a national center for education in the area of health management. By establishing health workers’ chambers the process of licensing was regulated and initiated. Professional satisfaction of the employees has increased based on the national survey in all the state health institutions, especially the satisfaction with the conditions of work, equipment and relations between the people. They are still dissatisfied with their income although the employee salaries in the health care system have considerably increased in the last period.

10. **Financing the health care system** is a critical point in the health care system reform in Serbia. The share of the overall costs for the health care in the domestic product was 7.6% in 2007 and it has slightly increased since 2000 (table 1). The per capita health care cost increased from 131 Euros in 2003 to 230 Euros in 2007 (the estimates say it will be 255 Euros in 2008). The IT system development in the republican Health Insurance Fund (HIF) resulted in the establishment of the insuree database and better control of costs and sick leaves. All debts were settled in 2007 and the financing of health institutions was stabilized. The medicines and medical supplies procurement was improved and the number of medicines from a so called “positive list” has doubled since 2004 (700 generic medicines). Around 1.2 million citizens of Serbia have no insurance and not enough money is allocated from the budget in order to provide the health care standard that 6.5 million health insurees and members of their families have, which badly affects the equity of the health care system and availability of health service to these vulnerable groups (uninsured, refugees and internally displaced persons).

Table 1
The health care expenditure in the Republic of Serbia from 2000 to 2006

Selected indicators	2000	2001	2002	2003	2004	2005	2006
Total health care expenditure as a % of GDP	7.1	7.3	8.3	8.3	8.0	8.0	7.6
External resources for health care as a % of GDP	1.1	1.2	0.5	0.5	1.3	0.5	0.8
State health care expenditure as a % of total expenditure	67.4	66.0	70.7	72.4	71.6	71.9	71.0
Private sector expenditure as a % of total expenditure	32.5	34.0	29.3	27.6	28.4	28.1	29.0
“Out of the pocket” spending as a % of the private sector expenditure	85.2	85.3	85.3	85.3	86.4	86.7	86.7
Total per capita health care expenditure (Euros)	51	84	131	170	199	212	247

Data source: The National Health Account (NHA) sub-project of the World Bank “Health Project in Serbia,” Ministry of Health of the RS, Belgrade, 2003–2008

11. One of the priorities in the following period is definitively the **change in the health system financing**. Unless there is change in the financing, so that money does not follow the existing structure and staff but the patients’ movements through the system, there will be no increase in the efficiency and quality of work as the most important intermediary goals of the health system. There were no considerable improvements concerning the payment of service providers for their work. As a result, there is low efficiency and productivity of work as well as a lack of incentive for improving the quality of the service provided to the citizens. At the primary health care level a doctor of choice is introduced as a “gatekeeper at the entrance to the system” and he will be paid according to the number of beneficiaries who decide to be treated by him. Capitation formula is being developed for several years with the support of the World Bank and the EU projects. At the secondary health care level a hospital payment system is being developed according to the model of similar diagnostic groups, but this process is still in progress, also with the World Bank’s support. The primary health care is much more interested in the introduction of changes in the manner of payment of the health service providers for their work while changes at the secondary and especially tertiary health care are accompanied by much greater resistance.

12. The operation of the National Health Insurance Fund should be considerably improved by strengthening the control and regulatory functions (control of the contribution payments is not within their mandate), especially at the level of subsidiaries the work of which is still insufficiently transparent. The population is getting old which will additionally burden the health funds. Thus, it is important to formulate strategies for obtaining financial means from other sources. So far, one dinar from every pack of cigarettes sold is the only additional source of financing the health care and it is spent for stimulating the promotion of health and prevention of smoking (1/3 of the total fund), purchase of anti-tumor drugs (1/3) and equipping the angio-hall (1/3) for improved diagnostic of cardiovascular diseases. One of the priorities is financial protection of beneficiaries from “out of the pocket” payments that can affect their standard of living, especially the vulnerable groups whose access to health service might be jeopardized. Thus, according to the new *Rulebook on co-payment (personal participation of insured persons in the health care costs)* the poor people who earn less than the minimum personal income are exempt from paying. The current political environment implies that the emphasis will be on the social justice and greater socialization of all risks which could slow down the changes in the area of financing.

13. Inclusion of the private sector in the health system will partially be realized through the development of a voluntary health insurance. The founding document is being prepared although it is still not certain whether this type of insurance will be a part of HIF or an independent institution. The licensing of health workers will provide an insight into the exact number of full-time employees in the private sector which is about to be better regulated although it was not identified as a priority in the health system development. The attempt to include this sector into the continuous quality improvement program failed although the reporting on the health service utilization and registered morbidity has improved. The private sector of the health system is subject to regular inspections in the last couple of years.

14. Priorities of the health care system reform concerning the level of health system management (so called good business practice) are advancement of management on all levels, especially better control mechanisms and greater accountability for the needs and expectations of beneficiaries, above all the non-medical expectations relating to satisfaction, better communication and enforcement of health care rights. The fight against corruption is also found in this group of priorities, especially charging for the services from mandatory insurance and transferring the patients to the private sector, as well as strengthening the inspection service for better quality control and work efficiency.

15. **Promotion of health and prevention of diseases** on all levels should be the basic strategic orientation for the improvement of health of the citizens of the Republic of Serbia having in mind that a lot has been invested into buildings, equipment and provision of medicines and medical devices. Development, careful implementation and evaluation of programs for prevention of risk factors, prevention, eradication and control of mass non-communicable diseases, screening, especially malignant diseases with timely and efficient treatment and rehabilitation – all those are just initiated activities and the results of their effect on people's health will be visible in the future.

Social Protection

THE REFORMS SO FAR

1. After the changes of October 5, the social security network was completely ruined, so the first activities in the social protection were directed to stabilizing the system. With considerable donor support the servicing of debts accumulating for many years has started, as well as establishing regular payments of remuneration, renovating the homes for beneficiaries' accommodation, etc. The long-term strategic orientations were formulated through the inter-sector and sector strategies, and above all through the Poverty Reduction Strategy (2003) and Social Protection Development Strategy (2005).

2. **The system of remuneration** was considerably altered by the legal amendments in the first years of transition. The Law on Financial Support of Families with Children (2002) and Amendments to the Law on Social Protection and Provision of Social Security of the Citizens (2004) brought about the annulment of differences in criteria for allocating the remunerations and the introduction of the single absolute poverty line on the republic level, providing the maintenance of actual remuneration value by indexing the cost of living, with continual access to rights. Moreover, the amount based on the right to have third parties' care and assistance for old and disabled persons was greatly increased, especially for the beneficiaries with the highest degree of disability. Along with that the measures of social policy were separated from the measures of population policy. Child allowance was defined exclusively as a social policy measure, the universal right to child allowance was revoked, the amount of the allowance became the same regardless of the order in which the children were born and better targeting of the poor was provided by precisely defining the income and assets that are taken into consideration in identifying the right. The families with children with special needs, self-supporting parents, foster parents and guardians were put in a much favorable position. Parental allowance (a one-off cash benefit given at the birth of a child) is introduced as a birth incentive measure.

3. While the number of financial family support (MOP) beneficiaries declined during the 1990-ies, mainly as a result of the fact that

remunerations were not regularly paid, the number of beneficiaries has grown after the year 2000, especially after the adoption of new legal solutions which were directed to that goal. According to the 2007 data over 50 thousand families receive the financial family support (MOP), which is approximately 130 thousand individuals. Over 3 billion dinars (only 0.12% of GDP) was allocated for this purpose from the budget. The average monthly amount was around 5000 dinars per family, and 2000 dinars per individual. Along with the funds from a national level, almost all municipalities in Serbia pay the so called one-off pecuniary aid, mainly to the same beneficiaries. The beneficiaries of financial family support with children have the right to receive the child allowance at the same time.

4. Contrary to these developments, the number of child allowance beneficiaries has declined as expected, in accordance with the new policy and it decreased from 590 thousand in 2001 to 430 thousand in 2007. At present the child allowance is 1700 dinars per child (the increased amount is 2200 dinars), and the overall financing cost is 7.6 billion dinars (0.3 % of GDP).

5. The latest Living Standard Measurement Survey in Serbia indicates that the changes allowed better targeting and aiming at the poor and that the efficiency of the social programs providing for most of the total spending of the poorest households has increased.²¹

6. There were two mechanisms for the implementation of reforms in the **social welfare service** area: reform projects and special funds for financing the projects at the local level. First the Fund for Financing the Associations of the Disabled Persons was established (2002) and then the Social Innovation Fund (2003); both as mechanisms for the alternative social welfare development, changes at the local level and the introduction of the NGO sector in service delivery. Both funds represent the mechanisms of decentralization and reform of the system since they finance the projects at the local level and new alternative services that are not a part of the system or are not developed enough. As a result of reform efforts in the service area there was a considerable increase in the number of children in foster families (from 1600 in 2001 to almost 4000 children in 2007, whereas there are only 750 children in the homes for children without parental care compared to over 2200 before the commencement of reforms); there was an increase in the number of beneficiaries of home care and assistance, day care for children and adults with disability; also the protected housing development has started, as well as personal assistant service and shelters for the victims of family violence. In the previous

21 Statistical Office of the Republic of Serbia, World Bank, DFID, Living Standard Measurement Survey – Serbia 2002–2007, 2007, page 76

year there was an improvement in the design of the minimum standards of social welfare service as well as in the support and monitoring mechanisms. In over two thirds of the municipalities in Serbia the design of the plans for social welfare development is in the final phase, well supported by the donors.

STRATEGIC ORIENTATION OF FURTHER CHANGES

It is necessary, in the medium-term, to examine the **cash benefits**, both from the aspect of targeting and administrative procedures and the aspect of census adequacy and the amounts of the benefits alone. The earlier surveys clearly showed the flaws of both institutes, for example, the right to child allowance of the families with children which are not poor (mistake of inclusion), excluding the right to financial support of poor families (mistake of exclusion), inadequate equivalency scales in the system of financial family support that are in favor of small households, excessive requests concerning the administrative procedures which, on one hand, include the elements of self-targeting, but on the other hand, create an obstacle for many of the poorest families to enforce their rights to cash benefits. In line with the redefined role of the social work center it is necessary to resolve the dilemmas concerning the identification of the administrative procedures for the enforcement of rights and further IT strengthening, both on the local and national level, in order for the system to function better.

7. Strategically, one of the important issues in this area is the inclusion of some form of active participation of cash benefits beneficiaries. The active participation can have different forms and it can be individualized, up to the level of a single beneficiary. In principle, it includes the conditioning of aid, but it can also mean additional amounts of cash benefits for certain forms of conditioning. Determining the amounts of additional benefits in case of a job engagement is surely one of the greatest challenges in designing the activation schemes. Depending on the identified basic problem the beneficiary may be referred to public works engagement, to retraining and additional training, to attend the adult education program but also to family therapy, therapy for addictive diseases etc. Within the child allowance institute it is possible to provide for high school children to enforce their right to child allowance not only if they attend the classes regularly but also if they attend the unpaid programs to gain practice and working experience, to have additional schooling, to belatedly finish the primary school etc. It is also of importance to carefully identify the beneficiaries who could be temporarily or permanently exempt from these programs, for example pregnant women and self-supporting parents with small children, individuals taking care of a severely disabled household member etc. Designing the activation schemes is a

special challenge having in mind the accessibility of certain services necessary for the implementation of programs on the local level. Including the activation elements into the social assistance scheme should contribute to the better targeting of cash benefits beneficiaries, exclusion from the “rights” of those engaged in gray economy, but also in the social inclusion of the most vulnerable groups. It is of great importance that the formulation of activation programs for social welfare beneficiaries is harmonized with the appropriate programs designed for the unemployed, both on the strategic and implementation level. It is also necessary to properly define the roles and cooperation between the local self-governments, social work centers and the national employment service.

8. Decentralization, deinstitutionalization and further development of alternative social welfare services remain the most important strategic development orientations in the **area of services**.

In the medium-term one can primarily expect the decentralization of competence in the area of services of residential protection of the old to Vojvodina and Belgrade. There is an option to transfer this competence to other cities in Serbia as well. In the same period one can expect the completion of reform processes in the protection of children and youth without parental care which would allow for this competence to be decentralized in the same manner.

9. Deinstitutionalization and further development of alternative social welfare services must be considered within the uniform reform efforts. Both processes are also inseparable from the process of institution transformation, in order to ensure that the resources trapped in the residential institutions do not represent an obstacle but an integral part of the system change. Further reforms include the reduction in the share of institutional protection, significant improvement in the quality of institutional protection for those beneficiaries for which it is still necessary and strong development of all alternative services forms. The objective of the medium-term reforms is for these so called alternative services to become the main form of protection and for residential protection to become a short-term solution, the last option.

10. The further development of alternative social welfare services includes the provision of additional funds for their financing from a national level. In the long-run, it is obvious that financing of the social welfare services within the local government’s mandate has to be continuously supported in a regulated way from the national budget at the central level. Instead of being unmarked, these transfers should be earmarked in order to ensure that they are not spent for other purposes but exclusively for social welfare. At the same time, it does not mean that every dinar would be earmarked according to the type and scope of the service it should be spent on. The transfer amount could be formulated

so that it is allocated to the municipalities on the basis of a formula that would consider the per capita fiscal capacity of the municipality but also the need for social welfare services. Due to the limited budgetary capacity in the medium-term, the additional funds from the central budget intended for the social welfare service development could be transferred only to less developed municipalities, for example, those whose local budget is below the national average and all in a form of some sort of complementary grants. Coming back to the topic of decentralization within this context, the main issue of social welfare service decentralization is not just the issue of “lowering the competence” from the central to the lower levels of government but it is also the issue of encouraging development of those services that are already totally within the local self-government mandate and the development of which is the ultimate strategic goal that needs to enable the advancement of the situation for certain vulnerable groups.

11. In the area of service delivery it is necessary to ensure the separation of the role of the service buyer/financier from the role of the service deliverer, to stimulate competition and include the non-governmental stakeholders in the service delivery area, to solve the issue of beneficiary participation in the service cost in a more rational way etc. At the same time, it is necessary to formulate and clearly define the new role of the social work centers and their function in the system. In the medium-term, Serbia should finalize the establishment of all regulatory mechanisms that are the necessary precondition of the further social welfare development: formulating the minimum service standards, rules for licensing and accreditation of the service providers but also the strengthening of control mechanisms on the national and local levels. Strengthening of the professional capacity is a particularly important precondition for the accomplishment of all strategic goals of social welfare.

PASSIVE AND ACTIVE LABOR MARKET POLICY

1. **The loss of a huge number of jobs** in the state-owned and socially-owned sector was an expected result of transition and commencement of privatization process in 2001. The challenge facing the economic policy makers was twofold. On one hand, it was necessary to provide a sufficiently generous compensation for the workers facing the loss of their jobs so as not to jeopardize their existence while they are unemployed, as well as to ensure the political sustainability of the reforms. On the other hand, it was necessary to increase the chances for employment of the unemployed people, both by improving their relative chances through participation in the active labor market programs and by stimulating greater employment opportunities in the economy as a whole.

2. Generally speaking, greater success was accomplished in temporary financial provision for the workers who lost their jobs than in their re-employment. However, the costs of the unemployment benefit and severance were very high and were growing over the observed period and the efficiency of their usage was questionable. Relatively small funds were spent on the active labor market policy and its range was limited. Broadly speaking, there was no consistent employment policy since, as a rule, no one took into the account the effects of general reform policies and employment measures and the possibility of creating new jobs.

Table 1
Funds spend on benefits

	Benefit, average number of beneficiaries	Benefit costs, in mil. din	Active programs, in mil. din	Benefit, % of the programmatic budget of NES	Active programs, % of the NES budget
2000	47,393	758	521	59.3	40.7
2001	51,156	2,429	1,057	70.2	29.8
2002	69,566	4,716	1,306	78.3	21.7
2003	90,995	7,891	881	90.0	10.0
2004	76,584	11,404	410	96.5	3.5
2005	63,295	12,639	1,545	89.1	10.9
2006	75,059	15,850	1,540	91.1	8.9
2007	71,334	17,920	2,165	89.2	10.8

Source: Financial reports of the National Employment Service, 2000–2007

3. The **unemployment benefit system** inherited from the 1990-ies was **rather generous** and characterized by high replacement ratio and benefits were received over long periods, up to 36 months; even much longer for certain categories. However, during the 1990-ies the share of the beneficiaries of the benefit in the number of registered unemployed persons did not exceed 5–6% which made it possible for the benefits to be fully financed from the unemployment insurance.

4. Although it was expected that the number of unemployment benefit beneficiaries would increase with the beginning of mass lay-offs, there was only a moderate increase, and the scope of beneficiaries has never much exceeded 10% of the number of registered unemployed persons (maximum number of beneficiaries – 91,000 was reached in 2003). The reason is the establishment of the

transition fund in 2002 which provided for the relatively high severance to the fired workers but with the simultaneous loss of the right to use the benefits.

5. The new law adopted in 2003 reduced the rights on the grounds of insurance in case of unemployment, but the rules remained relatively generous in comparison. The maximum duration of benefit receipt is 24 months. The replacement ratio was defined as 60% of the employed person's average salary in the last three months, with the reduction to 50% after three months of usage until the right to receive the benefit expired. However, since it was regulated that the minimum benefit cannot be lower than the minimum salary, for many beneficiaries the replacement ratio is considerably higher, and for some even higher than 100%. Having in mind the fast growth of the average salary and high replacement ratio, the overall expenditures for unemployment grew very quickly and in 2007 they reached 2000 million Euros, (almost 1% of GDP) which was almost 90% of the total programmatic budget of the National Employment Service.

6. **The transition fund was established in 2002** as a part of the Social Program intended for the surplus of employees with the aim to accelerate the restructuring and privatization of the socially-owned and public enterprises through the provision of stimulative severances (above the legal minimum) for voluntary collective dismissals, as well as to facilitate the re-employment of the "surplus" of workers through establishment of transition centers for counseling, training and additional education. Huge funds of almost 300 million Euros were cumulatively spent on payments of stimulative severances for around 150 000 workers in the period from 2002 to 2007, which on average accounts for around 0.4% of GDP a year. On the other hand, the transitional centers and other activation services of the Social Program did not show any significant results in the re-employment of the surpluses. The budget for 2008 provides for almost 90 million Euros to be allocated for severances through the Transition Fund. One should bear in mind that the overall sum of severances paid to the dismissed workers is considerably higher.

7. The implementation of active labor market policy programs belongs to the primary competence of the National Employment Service (NES). The reform of NES began in 2001 and it intensified after the adoption of Law on Employment in 2003. The intermediary and advisory work with the beneficiaries is particularly enhanced by introducing the individual action plans for those unemployed for a long time and members of vulnerable groups, then introducing employment fairs, job clubs and strengthening the contact with employees. The training programs remained relatively modest in scope. The two main programs in the area of employment subsidies are support to the

self-employment and the so called regional employment programs, as subsidies to the employers for new employment.

8. Despite the significant progress, the NES **still hasn't reached the satisfactory degree of efficiency**. The number of advisors compared to the number of the unemployed persons is very unfavorable. The mechanisms for monitoring, process evaluation and the evaluation of active programs' effects have not been established, as well as the system for forecasting the labor market flows. The greatest progress was made in the area of **intermediation and advisory service**. **The trainings** are mostly of a general type, and relatively small means are allocated for them despite the growing "skills gap". **Subsidies for self-employment** were given to a considerable number of beneficiaries, around 5000 a year on average but the new businesses survival rate seems (in the absence of official reports and evaluations) rather disappointing. On the other hand, the subsidies for the employers seem to suffer more from the deadweight effect, and they were awarded in a very arbitrary manner e.g. equally to the developed and undeveloped regions. **The public works programs** were also conducted during 2006 and 2007. In principle, they are mainly supposed to provide a temporary financial support and working experience to the discouraged, long-term unemployed, poor workers and in that way increase their future ability of being employed. In practice, this goal was sometimes in the shadow of subsidizing useful local activities relatively independent of the degree of engagement of the members of particularly vulnerable groups.

9. **Further reforms in the area of institutional regulation and practical implementation of the passive and active labor market programs are necessary**. It is necessary to change the Law on Employment and Unemployment Insurance in order to establish a consolidated annual planning of active labor market programs within the regular budgetary cycle, having in mind all the incentive measures for employment that are also being implemented through the other state agencies. That should be the first step to conducting the practical integrated national employment policy. The other recommendation for the amendment of the law concerns the introduction of stronger incentives for the activation of the unemployed persons, especially the unemployment benefit beneficiaries through reducing the period of receipt of the benefit and replacement ratio on one hand, and on the other, in case they find a job earlier, keeping the right to receive a part of the benefit until the maximum deadline expires. Finally, the process evaluation and the evaluation of the active programs net effects should be institutionalized.

Education

DEVELOPMENT SINCE 2000

1. The situation in the area of education was in many ways distressing in 2000: the teaching staff was lacking professionalism, the curriculum and textbooks were obsolete, the school network was inadequate and unrestored, the financing system was not transparent, the student achievements were low. In a situation like that the education reform became a priority. There are two directions of changes in the period after 2000:

2. **Stable growth of investment** into education, growth of salaries and investment into renovation and equipment of school buildings. The percentage of GDP set aside for education was increasing from 2.7% in 2001 to 3.7% in 2007 and there has been an evident stable growth of the employee salaries at the rate of 20–30% a year from 2000 and with a multiple leap in 2000 and 2001. The investments into renovation and equipment of school buildings have also considerably increased²² but in the budget of the Ministry of Education there is still an excessive share of salaries to the detriment of development programs, approximately 90%. The need for a successive increase of GDP percentage for education up to the level of 6% became widely accepted and stated in many inter-sector strategic documents in Serbia.

3. **The development of educational policy and education reform** with periodical cessations. There are two different phases of the education system reform in the period 2000–2008:

*The changes in the period 2000–2004*²³. The beginning of changes was marked by a new strategy of education development²⁴ based on the analyses and local consultations. The Law on Fundamentals of Educational System and Upbringing from 2003 encompassed all the anticipated and initiated changes in pre-university education with the

22 So, for example, the number of students per computer in high schools declined from almost 1:100 at the beginning of 2000s to around 1:18 in 2008.

23 For details see Kovac Cerovic, T. et al (2004): Quality Education for All. Belgrade, Ministry of Education and Sports, or Quality Education for All, The Challenges of Education Reforms in Serbia at www.see-educoop.net

24 T. Kovac Cerovic and Lj. Levkov (ed): Quality Education for All, A Way Toward the Developed Society, Ministry of Education and Sports, Belgrade, 2002

implementation period until 2011. New institutions for education development support were created, professional standards for teachers were introduced (licensing, professional development and advancement), as well as the new regulation of the curriculum based on outcomes and standards (national curriculum framework, school program) and new quality assurance system (external evaluation through final exams, national and international testing and redirection of the inspection system to the school quality assurance system). The school development planning became obligatory, the school autonomy was increased, the textbook publishing policy was liberalized and the introduction of the mandatory preschool education starting from 2007 was announced. The reorganizing of the vocational secondary school network began in line with the labor market needs (the new educational profiles started being introduced and the creation of the mixed secondary schools with different profiles was allowed). The preparations for the future decentralization of the system began at that time. The effects of these changes however, were not fully accomplished because after the year 2004 the reforms slowed down.

The changes in the period 2004–2008. With the adoption of the Law on Higher Education in 2005 the compliance with the Bologna process began. The Universities introduced the new curricula and reduced the duration of studies from around 11 years in 2001 to around 7 years in 2007. In secondary education the piloting of the new educational profiles continued and in 2006 the Vocational Education Development Strategy was adopted. However, the implementation is slow, due to the resistance of the teaching staff among other things. The experimental classes were introduced in 146 vocational secondary schools, with 53 new or innovated profiles in 13 areas of work, with the new curriculum and accompanied by teaching staff training and equipping the schools. Around 18,000 students (6.5% of the secondary school students) were enrolled into the new educational profiles in 2007. A new IT profile was introduced to comprehensive secondary schools (gymnasiums) with two classes each in 11 schools in central Serbia. In primary education, pursuant to the Amendments to the Law on Fundamentals of Educational System and Upbringing from 2004 a part of reform innovations was cancelled (curricula were again regulated through the content, the education system structure was kept in two cycles, the teacher licenses were not renewable) and the other part was postponed (external final exams). However, during this period the work on the school development plans was continued, as well as the in-service teacher training, liberalization of the textbook publishing policy and finishing of EMIS. The implementation of the mandatory preschool education began in 2006. The existing capacity, however, is not sufficient for the complete outreach of children, especially in the big cities. A School without Violence Project was initiated in cooperation with UNICEF in 2005 and 110 primary schools (around 10%) took part.

4. Despite the previous changes, the education system has still not responded to **several basic challenges**:

- *Low education quality.* The international surveys PISA and TIMSS for education outcome assessment at the end of the primary education show that the achievement in Serbia is below the average,²⁵ and the results from 2006 are worse than those from 2003. The pupils in Serbia are behind the average OECD achievement for about one year in mathematics and science, and about two years in reading literacy. This could be the result of inadequacy of the fact-oriented curriculum that does not prepare the pupils for the transfer of knowledge into the new areas and situations in life. A high dispersion of scores in Serbia cannot be explained by the influence of social and economic status or the regional differences but mostly by the differences among the schools and teachers, which points to the lack of standards regarding the quality of the teaching process and the teachers themselves.
- *The Roma children* are not covered by preschool education; only 30% of them complete the primary education and only 10% enroll further to a higher education level. Moreover, the Roma children are more frequently referred to special schools from which there is no access to further education or labor market. The Action Plan for the Roma Education is mostly not implemented.
- *Inclusion of children with special needs* into the regular kindergartens and schools began in 2005 but for now, it exists only as an initiative of the non-governmental and international organizations. The strategic documents that are supposed to regulate this area are still not adopted and the pilot initiatives in 10 cities in Serbia are taking place without clear guidelines from the ministry.
- Serbia is one of the rare European countries that did not pay attention to additional needs of *the poor children in education*. Although schooling is free, it requires substantial financial participation of the parents; the schools do not offer free or subsidized meals. The first step in giving scholarships to poor students according to the social criterion was not taken until 2008: 1000 scholarships and tutoring of the scholarship holders will be financed out of NIP funds.
- The system that should respond to the needs of *literacy, retraining and additional training* actually does not exist. The adult education was reduced from 80 schools in the 80-ies to only 14. The qualification training for employment is offered by the National Employment Service but only for known employers and without a certificate that would have a lasting validity. The Strategy for Adult

25 OECD (2004): *Learning for Tomorrow's World: First Results from PISA 2003*, and OECD (2006): *Assessing scientific, mathematical and reading literacy*. Paris: OECD Publications www.pisa.oecd.org

Education was adopted by the end of 2006 but it was not applied so far.

5. Inefficiency of the education system is growing. A constantly declining teacher to student ratio is an unfavorable indicator; it went from 1: 16.5 in primary schools and 1:13.6 in secondary schools in 2000, to 1:13.8 in primary and only 10.7 in secondary schools, while the OECD average is 15.2 and 13.0. Such a trend is financially unsustainable. It does not only reflect the demographic decline in the number of students but the increase in the number of teachers during the recent years. The increase was partially justifiable due to the introduction of new elective subjects, new profiles and limiting the size of the class to 30 students, but it is not accompanied by the reduced number of teachers in schools that educate the profiles of which there is a surplus. The main source of inefficiency is still the inadequate school network, i.e. a great number of small schools (more than 300 with less than 5 students).

FUTURE CHALLENGES AND POSSIBILITIES

6. The present education system shows serious signs of growing disfunctionality and inefficiency. Without some considerable change these system mistakes will only enhance which represents a serious risk for the development of the country. The priorities should be the following:

- *Develop an adult education system*, especially for the younger population (20–34 years of age, who represent around 50% of the unemployed) so that the premises and human resources of primary and secondary school are used to the maximum. Additional option and gain would be if the capitation formula would be used in payment for the adult education which would ensure the interest of schools and contribute to acquiring experience of the new way of financing.
- Accelerate and *finish the reform of the vocational secondary education* aiming at full compliance with the labor market needs. This asks for closing down the schools that educate the profiles of which there is a surplus on the market and expansion of new and innovative profiles. The status of the vocational subject teachers who are specialized in profiles that no longer have access to the market could be solved by severance, while other teachers could be redirected to the adult education.
- *Reduce the attrition in primary education*. The basic mechanisms for that are twofold: on one hand, it is necessary to enhance the social benefits for poor children (scholarships, meals, textbooks), and on the other hand, to increase the attractiveness of learning and quality of the teaching process through the curriculum reorganization, in-service training of the teachers, new quality

assurance mechanisms etc. The results of these changes will also contribute to the increase of the primary education quality.

- Increase the capacity and quality and prolong the duration of *preschool education* in a selective way, i.e. use the positive effects of early learning to the maximum, especially for the vulnerable groups. A good option here would be to have the financing according to the capitation formula with stimulative weights for inclusion of the children from vulnerable groups and transfer of means from the budget to the municipalities, since the responsibility of the municipalities in this education segment is already the greatest. Until the system has been completely set up it is necessary to introduce an affirmative initiative for the enrolment of children from these groups.
- Gradually introduce a new way of *financing education according to the capitation formula* in order to raise the internal efficiency of the system. Along with the piloting of capitation formula in preschool education and adult education, it is necessary to carefully try out the weights in city schools, but also in the environments where education is inevitably more expensive (where the ethnic minorities live, around Roma settlements or in the areas where small schools are located). The introduction of a new way of financing should happen in phases within several years, with the possibility of postponement for the municipalities with low capacity and/or the necessity for serious school network adjustment. Special attention should be paid to make the weights seem stimulative and to include the children with special needs and children from vulnerable groups.

7. **Decentralization.** Despite the initial attempts to increase the role of municipalities and schools, the education system remained highly centralized and the first experiences abounded in negative examples (political disputes within the school boards, the municipalities defaulting in payment for the in-service training etc), so the responsibility of parents and school accountability towards the beneficiaries were reduced rather than increased. Since the education standards have not yet been adopted, the issue of access to education has not been solved, EMIS has not been completed, the final exams and all the other control mechanisms have just started and there is not enough educational policy knowledge on the local level, the swift decentralization without the necessary preliminary requirements would not contribute to the education quality increase. However, in order to have a long-term efficiency, the preparations must continue.

8. There are **three more additional challenges** that need to be quickly addressed with special attention:

8.1. *Teaching staff.* Serbia still does not have a coherent policy regulating the teaching vocation (attracting, educating, advancing the teachers and promoting the teaching profession and competencies). The ongoing higher education reform could, to a great extent, respond to the needs of pre-university education and creation of contemporary staff through interdisciplinary teaching, increasing the share of practice in the preparation of teachers, inter-university links in order to obtain teacher competencies and offers for lifelong learning of the teachers.

8.2. *Financing.* Apart from the insufficient designation of funds and internal inefficiency, Serbia is not using any other potential sources for increasing the allocations for education. Neither the donations for education nor the employers' investments are encouraged.

8.3. *General knowledge of the system* and educational policy options in Serbia is very low. There are no specialized studies or institute for education policy, the financing of applied research is poor, and the publications in the area of education policy are not a part of the practice. Therefore, simultaneously with the reform implementation, it is necessary to increase the knowledge of this area both among the professionals and in general public, and by doing so ensure better understanding of the changes and greater participation in them.

Pension Insurance

1. Generally speaking, the **pension system in Serbia is still facing serious difficulties**. It seriously burdens its financiers (the employees and the budget) while pensioners believe they receive insufficient pensions. A system no one is satisfied with is doubtlessly at crisis point. According to the financial aspect, pension system is undergoing crisis since it has been facing considerable deficits in revenues in comparison with expenditures: Pension and Disability Insurance (PIO) Fund's deficit is sometimes hidden, sometimes open, but always present.

2. Peak of difficulties in pension financing was reached in the course of 1990-ies, during crisis, UN sanctions and economic regress, with redundancies, avoidance of contribution payments and widespread gray economy. Financing urged for more inventive solutions, particularly due to the fact that pensioners were a significant electoral body. Hence, adjustment to reduced resources was not carried out by formal decrease in pensioners' rights, but by applying other methods: twelve pensions were rarely paid during one year, in the period 1994–1995 pensions were reduced in illegal manner – by an ordinary act of the Serbian Government (this resulted in the so-called large debt), the pensions were paid in tokens for electricity; since the pensions were several months late the debt to pensioners was constantly devalued through inflation etc.

Latest basic figures are the following:

Table 1
Pensioners 2007

	Average pension, RSD	Number of pensioners
Employed	14,996	1,279,239
Self-employed	14,533	48,491
Farmer	5,613	229,392
Total		1,557,122

Average pensions in February, 2008 were 17,789 (employed), 17,340 (self-employed) and 6,650 (farmer), which resulted in the total average pension of 16,610 RSD.

HISTORY OF CHANGES

3. Several important steps in pension system reform were made in the course of 2001:

- regular payments of twelve pensions per year were achieved,
- pension reform strategy in Serbia was examined and it was concluded that there was no need for a reform by the so-called three-pillar World Bank's model due to significant transition-related expenses, underdeveloped financial market in Serbia and insufficiently convincing experiences of other countries; advantage was given to the reform of existing public pension system and introduction of voluntary private insurance,
- pension contribution rate was lowered from 32 to 19.6%, which, together with reduction of other contributions, was supposed to stimulate employment and abandonment of gray economy; Pension Fund deficit was covered by the Republic's budget,
- pension age limit was raised by three years, from 55 to 58 for women and from 60 to 63 for men, with a minimal age limit raised from 50 to 53; hence, Serbia caught up with other transition countries that started with these changes earlier, but mainly opted for gradual raising of the age limit; the main purpose was to downsize the number of pensioners in medium-term timeframe,
- pensions were no longer indexed in line with the salaries; the so-called Swiss formula was introduced, i.e. pensions were harmonized by combining the pay increase and costs of living increase, with the same weight; thus, the average pension increase was decelerated in terms of average pay increase, in order to decrease the already unsustainable deficit in the pension fund.

A very rapid growth of real salaries in the course of the following years resulted in higher pensions, regardless of the Swiss formula that was supposed to slow this process down in comparison with the salaries, which it did. However, salaries went up quicker than the GDP. At the same time, the raised retirement age limit brought about more moderate effects during the first application years, whereas decrease in the pension contribution seriously deteriorated the pension system finances, as well as the budget.

4. The new Law on the Pension and Disability Insurance from April, 2003 was the next step with the following crucial changes:

- definition of pensions on the basis of salary during the whole service, which improved the equity of the system, but failed to bring any direct financial effects,
- compulsory pension insurance categories were expanded and compulsory contributions were paid for authors' fees and work in students' cooperatives, which increased revenues by several billion dinars,
- certain categories of insurees' huge benefits were reduced and, what is more important, stricter and more narrow rights were introduced for disability pensions. This, together with greater control of exercising these rights significantly slowed down the inflow of new disability pensioners. Their current excessive number will, however, still burden the fund's finances for a long time,
- with reference to insurance of agriculturalist, which is in permanent collapse, insurance liability was reduced to only one household member and certain relaxations were granted for debts settling, which should have increased their interest in joining the system and paying the contributions. This however did not take place.

5. Slow implementation of former pension reforms, as well as certain deterioration of macroeconomic performances resulted in new changes in pension regulations in 2005, supported by IMF:

- retirement requirements were tightened up, i.e. the age limit was raised by two years, both for the old age and family pensions, which is a continuation of the age limit raising policy initiated in 2001; the goal was again the same – to reduce the number of pensioners in the long-term; this change will be carried out in course of four years and all envisaged values should be reached by 2010,
- index allocation mechanism was altered: the Swiss formula (equal weight of price and salary rise) was replaced by costs of living indexing. This is a radical conceptual change since pension rise would lag even more behind the salary rise. Hence, pensioners would not be able to take part in the country's economic progress, but would be constantly maintained on the same real income level (this may not take place if inflation is high, and only twice a year due to revalorization); two solutions have been envisaged for transitional regime: firstly, transition from the Swiss formula to costs of living to be implemented gradually until 2009; secondly, by the end of 2008, the average pension should not be reduced to below 60% of the average salary, otherwise special corrections are to be made and average pension increased to 60%.

6. The 2005 amendments to pension regulations would result in significant savings in a part depending on indexation and raising the age

limit, but only after 2010, when, on one hand, all pension fund debts are settled towards the pensioners and when, on the other hand, transitional solutions give way to basic solutions that should come in force.

Nonetheless, the application of this solution related to pension indexation by costs of living may not last long since pensions in Serbia are not very high and the expenditure control policy through non-increase of real pensions may hardly be acceptable for a longer period of time in a poor, developing country. It is unfair to exclude for a long time one segment of the population from enjoying the economic growth results. Thus, there have been more and more requests lately urging for the change of indexation mechanism, even before it fully came into power.

Speaking from the financial aspect, 2001, 2003 and 2005 reform changes of the pension system brought alleviation, but did not resolve fundamental, long-term issues related to its functioning. Moreover, changes resulting in biggest savings are very hard to sustain for a longer period of time, which implies that improvement of the pension system financial position is of a limited duration.

BASIC ISSUES

7. **There are two basic issues** related to the Serbian pension system:

The first one is *short/mid-term* and of financial nature: high expenditures (310.5 billion RSD in 2007), i.e. a very high share of Pension and Disability Insurance (PIO) system expenditures in the gross national product (12.5% GNP in 2007), which decreases the standard of living and hinders economic growth. This percentage is common in modern world – similar percentage is to be found in a number of European countries (Italy, Austria, France, etc.) – but there are also many countries with significantly lower burden. All countries with similar share undertake reforms to reduce it, to disburden economy and make it more competitive in the global market.

The second one is *long-term* and demographic: the number of active insurees and pensioners ratio is deteriorating as time goes, which increases pension financing burden; this ratio in Serbia today is only 1.6: 1, which implies that one pensioner is financed by 1.6 employees; this is partly caused by a very low employment rate in Serbia and partly by ageing of the population and worsened young to old people ratio. This ratio should be 3:1 or more for facilitated pension financing.

POSSIBLE SOLUTIONS

We would review four options for overcoming these difficulties: the first two deal with short and medium-term and the other two with long-term solutions.

8. The first option: do not undertake anything. It is based on a belief that pension system has been well adjusted in the course of the last reforms, that it cannot be significantly further improved without bigger social and political expenses and that it is necessary to wait for a certain period of time so that full positive effects of the current reforms are visible. This would, then, considerably improve the financial position of both pension system and pensioners themselves in medium-term and long-term period.

The future effects of the age limit increase are in favor of this option that will downsize the number of pensioners. The current indexation mechanism would be able to improve even more radically the financial position of the pension system; however its longer duration is practically unachievable, due to this very radical characteristic and maintaining of pensioners at the current level of purchasing power. Since indexation will definitely be changed, then future effects of economic growth on the pension system would depend on a chosen indexation mechanism. There is one cruel rule here: the more favorable indexation is for the pensioners, the less favorable it is for the pension system. Topical political agreement to increase the average pension to 70% of the average salary and return to indexation of pensions by incomes is particularly risky since this will put a great pressure on the Serbian budget.

9. The second option: further changes of the current pension system parameters in restrictive direction. There is, however, not much room left for such changes after the latest changes to pension system in 2005. The age limit for retirement was raised to 65 for men, which is, in the long-run, an acceptable maximum not only due to political reasons, but also for social and health-related reasons. There is no maneuvering with pension indexation for further deceleration of real pensions' growth. Moreover, it will change in a more favorable direction for pensioners.

The financial position of the pension system may be enhanced by increased pension contribution rate. This is, nonetheless, usually avoided lest workforce becomes more expensive, competitiveness and investment attractiveness is worsened and employment fails to be stimulated. In addition, experiences show that tendency to avoid payment of contributions is seriously increased at contribution rates over 20%, including the escape of the employees from the formal to the gray economy.

The age limit for the retirement of women may be the only serious candidate for a more restrictive policy in the forthcoming period. It is now five years lower than with men in Serbia, which is obviously unfair and has been abandoned in the world, like in Slovenia for example. Particularly when we know that the average lifespan of women is longer than that of men. Obstacles to this change are exclusively of political character, i.e. the reluctance of governments so far to face probable women's protests.

10. The third option: reform according to the so-called World Bank model, which has three pillars (components):

- state-run, non-funded, based on current financing and modest by its range, as provision of minimal income in the old age,
- compulsory, private, capital funded, based on individual saving accounts, and
- private voluntary.

The reasons that made the 2002 Government abandon this plan may be valid even today:

- it is neither certain nor proved in economic theory and other countries' experiences that this type of reforms resolve pension issue, i.e. bring benefits to both country and pensioners,
- this type of reform imply high transition cost since one generation of employees should pay two pensions – of current pensioners and their future pension through savings,
- it is not certain that today's insufficiently developed capital market in Serbia would be able to sustain this high inflow of pension capital and ensure high return, and
- it is not certain that the current state's regulatory and monitoring capacity is sufficient to provide the proper functioning of the private pension funds.²⁶

11. The fourth option: capitalization of the existing pension system, i.e. the creation of financial reserves that would be able to, at least partly, finance the future, ever greater, obligations towards pensioners. The new investment fund should be the institution in charge. Resources for the fund would be provided by the state mainly from the public enterprises capital and shares left after privatization and they would bring return on investment (shares, bonds, etc.), and the fund would, at estimated moment, start (co)financing pension obligations of the Pension and Disability Insurance Fund. To sum up, it is easier to finance tomorrow's pensions from an additional capital fund then without it.

Many countries have such a fund. It has proved very successful in a number of developed countries (Canada, Ireland, France, New Zealand, Spain, the Netherlands, Norway, etc.), on the basis of professional management and focused on commercial objective only during investing – maximization of yield. The crucial issue for Serbia is whether the following could be provided: (1) money for the fund, in a competition with various consumption forms, and (2) good fund management, which implies professionalism and without the state's interference.²⁷

26 The Study will be completed soon by J. Bajec, G. Matković, B. Mijatović and K. Stanić: *Introduction of compulsory private pension funds into the Serbian pension system – adequacy and feasibility*, dealing with the issue.

27 See a study by B. Mijatović: *Capitalisation of the pension insurance in Serbia*, CLDS, 2008.

Apart from these huge conceptual issues, it is also necessary to resolve the important issues related to the agriculturalists' insurance (low payment of contributions; alternatives: termination of unpopular insurance with insurees or serious intensifying of payments collection), military pensioners (issue related to integration into existing civilian system), pension administration efficiency (collection of payments, insurees' registry, etc.), introduction of social pensions (for those without pension insurance; it would significantly increase the expenditures), etc.

Governance in Serbia: Key Obstacles for Its Improvement

1. The governance in Serbia is analyzed according to six basic elements, i.e. governance indicators:²⁸ (1) democracy and accountability; (2) political stability and absence of violence, (3) government effectiveness, (4) regulatory quality, (5) rule of law and (6) control of corruption. Based on the available assessments, composite indices were established for each of the stated indicators (maximum value is 2.5 and minimum value -2.5; the higher the value, the better the governance).²⁹

Table 1
Governance quality

Governance criteria	2005	2004	2003	2002	2000	1998	1996
Democracy and accountability	0.12	0.11	0.14	-0.30	-0.29	-1.05	-1.45
Political stability and absence of violence	-0.91	-0.89	-0.90	-1.03	-1.33	-2.01	-1.29
Government effectiveness	-0.31	-0.12	-0.50	-0.61	-0.80	-1.11	-0.71
Regulatory quality	-0.53	-0.52	-0.68	-0.62	-0.90	-1.90	-1.45
Rule of law	-0.81	-0.78	-0.97	-0.99	-1.14	-1.06	-1.26
Control of corruption	-0.55	-0.55	-0.55	-0.77	-1.13	-1.03	-0.98

Evidently there was a significant and sustainable change for the better in Serbia in the last ten years and this finding cannot be affected even by certain fluctuations recorded after 2000. Even more so, since these fluctuations are smaller than the standard error of estimation of each of the composite indicators.

28 Kaufmann, D. *et al.* (2006): Governance Matters V: Aggregate and Individual Governance Indicators, World Bank Working Paper

29 All the data downloaded from www.govindicators.org.

2. **The legislative power** in Serbia has been formed at multiparty parliamentary elections since 1990. During the first years of multiparty system there were some problems in the election process itself but in time the elections became free and fair so, in that respect, Serbia is a mature democracy at present day. The existence of a proportional electoral system (regardless of a relatively high census) enables a great number of relatively small parties to survive in the parliament i.e. it results in the need to create complex and often ideologically contradictory coalitions that affect the functioning of the executive power. It is probable that the advantages of a proportional electoral system in the early phases of a multiparty system have already been exhausted, so the issue of electoral system reform arises probably in order to guide towards the introduction of the elements of a majority electoral system.

3. A great number of presidential and parliamentary elections in Serbia in the last eight years held without any significant incident and with power being peacefully handed down by those who lost, shows that Serbia has entered a mature phase of democracy although accountability still, more or less, boils down to the elections. The freedom to express oneself and to organize enables the accountability. However, this accountability is made difficult by the media environment in Serbia which, although there is no strict government control, is still greatly influenced by the political parties and interest groups.

4. All the relevant political players in Serbia accept the political framework defined by the constitution and the chances for political violence on that ground are very slim. The problems regarding the political instability and the chances for political violence to occur, exist in connection to political developments that are not directly linked to the political scene in Serbia and its competition (above all, the Kosovo status).

5. The National Assembly as the legislative body has not shown any greater self-initiative so far in the law making process, especially regarding the influence on the content of the law, i.e. the coordination between the different laws that affect the same government policies. The dominance of party politics i.e. the dominance of the executive power in the Assembly is reflected in the fact that a great number of laws has been passed at the Government's proposal and at emergency sessions, without public discussion and possibility to discuss argumentatively the good and the bad sides of the proposed law. The greatest number of laws was adopted in the same form as their proposal and the ruling majority in the Assembly provided the "voting machine". Thus, by saving time, the number of laws passed has increased (especially in the period from 2004 through 2007) but there is a decline in the quality of legal solutions and their mutual compliance. The National Assembly practically does not have professional staff that could provide unbiased support partywise to the MPs, i.e. to the appropriate boards in the

discussion on the legal proposals. The national assembly institutional capacity building project did not come across the support of the MPs, i.e. the parliamentary political parties.

6. **The executive power** in Serbia, especially since 2000, has been based on constituting large and fragile coalitions. This situation is a result of a fragmented Serbian political party scene and sustainable division of voters. That is why not a single political party can form the government independently, so they are forced to form a coalition. Therefore, these coalitions arise from necessity and usually there is not even an elemental ideological closeness between the coalition partners. Moreover, there is no mutual trust between the coalition partners which results in a so called vertical division of executive power in which a particular political party on its own completely controls the ministry assign to it (“vertically”). In this manner a certain balance within the ruling coalition has been accomplished since every party is unrestricted in its own ministry. Such organization of executive power inevitably leads to its growing “politicalization” in a sense that there is a dominance of party policy over the interests of an efficient executive power. Furthermore, such division diminishes the possibility of creating a professional, non-partisan public administration since there is a strong incentive to each political party to appoint “its people” to the ministry under its control. Although the introduction of a state secretary function and redefining of the position of assistant minister have been, at least allegedly, motivated by bringing professionalism into the state administration, it turned out that, among other things, due to such coalition structure and vertical division, it resulted in appointment of politically suitable staff.

7. The coalition trait of executive power (the coalition coming out of necessity and not ideological or program closeness) inevitably resulted in the fact that the executive power structure became absolutely subordinate to the coalition needs in order for all the coalition partners to be satisfied. That is why the number and composition of ministries drastically varies i.e. the number and job description of the deputy Prime Minister, in order to find a suitable position for each key player. The functionality of solution comes second. Especially in the case of forming the so called “super” ministries (like the Ministry for capital investments), it leads to neglect of certain areas which are not a priority for such ministries (like for example, utilities). Such organization of executive power is also very unstable since after each elections there are new elements for forming a coalition, i.e. new ambitions of coalition partners.

8. Such organization of executive power creates great problems in passing strategic decisions regarding the public policies, especially those that affect numerous sectors and thus, exceed the competence of one

ministry. The consultancy process is reduced solely to the fact that ministries give their opinion on, for example, a draft law. Those opinions are very often an element in the process of political trade in which the services between political parties that compose a coalition are exchanged. There is no formalized process for the Regulatory Impact Analysis which means there is no possibility to check the consequences of passing a certain regulation. Only the existence, i.e. the function of the Legislative Secretariat provides some kind of internal consistency of regulations proposed by the government i.e. their compliance with the Constitution. Since a huge majority of laws are passed according to the “urgent procedure” the public discussion on the draft law where experts and all the stakeholders could express their opinion, comments and suggestions is becoming very uncommon. The ministries are not at all involved in the advocacy of the public policies they are proposing, either within the government itself, or in the wider public. The executive power does not feel the need to do anything like that at all. Everything mentioned is causing a very low quality level of the public policies i.e. the propositions of the laws submitted to the National Assembly by the executive power.

9. The executive power in Serbia is followed by an inherent political instability. Since the introduction of a multiparty pluralism in Serbia only one government has lasted the whole mandate and not a single government has managed to do that since 2000. Besides the already mentioned fragmented political scene, the instability is caused by numerous exogenous factors i.e. external political shocks. In such conditions, the executive power of a very uncertain duration and already mentioned incentives in the area of party politics is not encouraged to start a comprehensive public administration reform, since it is focused on obtaining the maximum benefit while in power with high discount rate. Although the Government has passed the Public Administration Reform Strategy the final goal of which is “to ensure a high quality service to the citizens and create such a state administration in Serbia that will greatly contribute to the economic stability and quality of the state standard”, it is evident that in case of the state administration reform the Government is focused on this segment of administration that directly communicates with the citizens, and to a lesser extent to that state administration segment that would provide the increase of the governance quality, i.e. the business environment improvement.

10. Although the situation in the public administration is not satisfactory, there is the impression that there is no considerable falling behind the other comparable countries, especially not after eight years of transition. It became evident during the preparation of the SAA (Stabilization and Association Agreement) that the administrative capacity of the public administration is relatively high, especially compared to some other

countries in the region. However, considering the domination of the party politics in the process of passing and implementing the public policies, it is of key importance in Serbia to provide the strengthening of the public administration independent of the party politics and increasing its mandate in forming the public policies on one hand, and implementing the public policies on the other, in order to provide the rule of law in the widest sense of the word i.e. the rule of unbiased laws and equality of all citizens before the law and those who enforce it.

11. The basic problems of the public administration come from its heritage, especially from the 1990-ies. While during the communist rule the public administration was relatively well developed and capable of accompanying the functioning of the state in the socio-economic system of that time, the disappearance of that system brought, on one hand, completely new demands and a need to adjust the public administration to the new, and in many ways unfinished institutional framework, and on the other hand, completely discredited the state governed by the private interest groups and thus the public administration itself. The aforementioned discreditation followed by inadequate salary policy in the state sector lead to the adverse selection. On one hand, majority of the best civil servants transferred to work in appropriate jobs in the private sector that was able to offer much higher salaries. On the other hand, people without integrity joined the state administration to some extent and for them the possibility to earn money through corruption was far above the expected income from regular salary. Although this process was present in all the segments, this adverse selection was nowhere so evident as in (at that time, Federal) Customs Administration.

12. The unresolved government issues, like the future of the common state of Serbia and Montenegro, made the public administration reform (its modernization and professionalism) difficult, in a sense of separating it from party politics. The dissolution of the federal state, for example, lead to a drastic increase in the number of employees in the national public administration (from 8,000 to over 27,000), far exceeding the needs occurring with the transfer of functions from the federal to the republic level. It resulted in the need to solve the burning issue of surplus labor which pushed the essential state administration reform aside.

13. The key political decision-makers, i.e. the political parties do not see any benefit from the public administration reform and increasing of its efficiency. For them, such administration represents only the limitation of the short-term goals realization while the long-term goals are not of greater importance under the conditions of high discount rate of politicians. Therefore, until now the key players did not have an autochthonous motive to reform the state administration but they did that unwillingly, mostly under the pressure from the donors,

i.e. the international factors. In other words, there was no political will for a serious, thorough and comprehensive state administration reform and the little that was done was mostly due to the reduced maneuvering space with regard to the international factors.

14. Even though the period of the worst adverse selection regarding the public administration was certainly over already at the beginning of this decade, there is still the problem of recreating the adequate public administration staff. Namely, the development and strengthening of the private sector in the country, especially with the creation of new jobs due to the foreign direct investments, leads to the salary increase for competent people, especially those seeking employment for the first time. The current state administration salary system is simply not competitive and disables the administration to attract the most competent people. Besides, there are no specialized educational institutions for training the state administration staff at the level of specialized graduate studies (Masters).

15. The said situation in the public administration and rather gloomy prospects for its further reform and qualification directly affect the governance, first of all in the area of support to the key decision makers in the process of formulating and applying the state policies, i.e. with regards to the governance. The key decisions are still made and implemented according to the “political feeling” in the surrounding where administrative and professional capacities are still rather low. The decisions are not made on the basis of topical discussion in which there would be a thorough analysis of both good and bad sides of every possible decision, i.e. the discussion where alternative options would be ranked and decisions made based on the concept of opportunity costs – what is missed by making a certain decision, i.e. by opting for a particular state policy.

16. New demands, i.e. challenges of governance that the state authority (the executive power, primarily) is faced with, in conditions where little was done to reform the public administration, resulted in the fact that the existing public administration could not offer solutions for these demands in many segments. Since the existing institutions, i.e. state bodies could not successfully and quickly be reformed, all the governments, starting from the year 2000, started establishing numerous new institutions (bodies), mostly new agencies and administrations. Even when the executive power was not directly competent for their establishment (like independent agencies, i.e. regulatory bodies), then it was the initiator, most frequently by proposing the appropriate law. Very often a surplus of bodies was formed, with unclear mandate and competence that was overlapping with the already existent bodies. That was the result of two factors. First, the unclear concept, i.e. the state administration reform strategy – no one knew what the purpose was. Second,

the influence of the international factor; different representatives of international organizations i.e. different donor organizations were expressing their views on the “best practice”, that is to say, their opinions on how the regulatory framework should be formed. The lack of local knowledge in this area, as well as the lack of motives to enter into the discussion and potential conflict with the international factors, enhanced their activity even more.

17. The **new regulatory bodies** and the process of their establishment were accompanied by numerous problems, like providing the appropriate financing (budgetary funds) and adequate business premises; the establishment also became more difficult because of the search for suitable personnel acceptable to all. The delay in establishing the regulatory bodies was also accompanied by slowness, actually by falling behind in passing the appropriate bylaws (at all levels: legislative power, executive power and the regulatory bodies themselves), so the newly formed regulatory bodies, even though they were established, could not start working and fulfilling their duties. Hence, those who were primarily supposed to take into account the enforcement of law, by their behavior caused the situation where the laws that came into effect were not implemented. This resulted in a paradox – instead of reducing the regulatory uncertainty, which was allegedly the idea behind the establishment of new regulatory bodies, it was increased since there was no sign as to when, for example, the legislative body or the executive power would pass the appropriate bylaws. The technical part of this problem could probably be solved with the introduction of a suspensive effect category (concerning the entry into force – *vacatio legis*), although it is necessary to ensure that those who pass the bylaws have a strong incentive to do that before the suspensive effect deadline expires.

18. A huge number of newly established regulatory bodies have the status of independent bodies i.e. the bodies that are, or should be more independent from the partisan politics and private business interests than the executive power. The main precondition of regulatory body independence is to be elected by the parliament and not appointed by the government. The results of a detailed analysis of the independence degree of Serbian regulatory bodies, based on the generally accepted modern technology, are given in the table below.

Box 1

Securities Commission

Securities Commission was established in 1990 and the members are appointed and dissolved by the National Assembly. So, the Commission belongs to the independent (of executive power) regulatory bodies. It is under its competence to regulate all the securities transactions, i.e. all the procedures in those transactions. The Commission has sufficient competence but not a complete regulatory capacity so it could not be said that Commission is adequately fulfilling its competencies. In many cases, however, there is no way for the Commission to directly implement its decision. For example, the Commission may order the enterprise to publish the prospectus but it cannot force the enterprise to do that, in other words, it does not have the mechanisms to punish the enterprise that avoids doing that. Furthermore, in some situations the Commission has no wider range of possibilities for punishment, and it can apply only the most severe one (for example, taking the permit away from a broker), and that is why it is abstaining from any such measure. The party in the dispute in which the Commission makes the decision or declares a sanction, has the right to institute an administrative dispute (a perfectly excusable procedure of including the next instance), but instituting the administrative dispute prevents the enforcement. Also, the Commission has little possibility to work on the prevention of market disruptions, for example, in the case of “market integrity protection”, primarily caused by manipulative activity.

The Commission has a possibility, in accordance with the law, to pass the bylaws. However, the current version of the Law on Securities has considerably limited the original competence of the Commission in creating the regulatory norm, primarily concerning the different rulebooks that define the manner of work, i.e. the way the Commission itself has to act in different cases. By charging the legally prescribed fees, the Commission acquires original revenues that are higher than its expenditures, but has no possibility to autonomously manage its revenues and define its budget. Furthermore, the Commission's independence regarding the personnel is also in danger since the process of candidacy and selection is performed in the Assembly but under great influence of the political parties. The number of Commission employees is not sufficient, even more so since many of them are not qualified in order to perform efficient work in this regulatory body.

The main dilemma concerning the future of this body is the concept of the financial services regulation. The growing number of countries is opting for a concept of one regulator of integrated financial services that, along with the securities market and its organizations, would include the banking services, insurance etc. Such concept means the central bank would be reduced to its monetary policy function. The outset of such integrated regulator however, may be within the central bank itself; in other words, establishing a separate department of the central bank for regulation of integrated financial services

Table 2
Independence of regulatory bodies

Title	Condition to get 1 point	Commission for Protection of Competition	Broadcasting Council	Energy Agency	Telecommunications Agency	Securities Commission
The President and the members are elected by the Assembly	yes	1	1	1	1	1
Members are proposed exclusively by the government	no	1	1	0	0	1
Technical knowledge of the area requested	yes	1	1	1	1	1
Fixed presidential mandate	yes	1	1	1	1	1
Possibility of a second mandate	yes	0	1	0	0	0
Duration of the mandate	>3 years	1	1	1	1	1
The government's consent on the budget is necessary	no	1	1	0	0	1
Someone's consent regarding the pricelist is necessary	no	1	0	1	0	1
Passing decisions in collective manner	yes	1	1	1	1	1
Complaint exclusively to the court	yes	1	1	0	1	1
"Quarantine" after the mandate has expired	yes	0	0	0	0	0
Number of points		9/11	9/11	6/11	6/11	9/11

19. The scores in the table show several things. Firstly, from a formal point of view, the institutions are relatively highly independent. Secondly, those that perform the task that practically no one has performed before them are more “independent”. Two institutions (dealing with energy and telecommunications) are significantly less independent than the other three according to this analysis. The possible explanation is that this was the case of transferring the competences from the ministries that were unwilling to accept that and thus, contributed to the fact that even the formal independence was at a lower level.

Box 2

Commission for Protection of Competition

The passing of the Law on Protection of Competition in 2005 facilitated the establishment of a modern body that is supposed to deal with antimonopoly policy, i.e. the policy of competition protection. The problem is that the Law is inappropriate since many of its provisions are not well formulated. Since the law prescribes a very low threshold for notification, i.e. concentration approval, the Commission was swamped with a huge number of requests from the start which resulted in unnecessary delay of the concentrations (mergers and acquisitions i.e. takeovers). There was a financial incentive for such behavior since according to the Commission pricelist there was a high charge for these “services”. The Commission’s competence is too wide and it was focusing on the most controversial area of competition protection policy (concentration control) and spent a lot of effort on a couple of big cases, instead of dealing with far easier and indisputable issues in the area of competition protection, like abuse of dominant position and especially, horizontal agreements, i.e. cartels. The Commission does not have the right to punish but only to order the restoration of the previous condition. Punishing, by a very odd legal solution, belongs to the competence of the low level administrative courts. Still, the Commission’s competence is very wide and it is not adequately fulfilled since there are no essential resources. The wrong strategic decisions within the Commission itself led to such Commission’s operation. Although the comparative experience showed that the bodies for the protection of competence should concentrate in their early phase on the advocacy of the competition protection idea, the Commission did not address that issue at all.

The Commission has very high revenue, since it is charging for its services. A very low threshold for registering the concentration and a huge number of cases in which the Commission considers the concentration and charges for this service resulted in the revenue that is higher than the expenditure. However, the Commission does not have a sufficient number of employees, especially if one is to consider the staff competence. Namely, the greatest number of employees of the Commission is taken from the former federal Antimonopoly Commission and is simply not capable of performing the tasks of competition protection in the market economy.

Although the law is comprehensive, its implementation is linked to numerous bylaws. So far a certain number of acts have been passed and from a formal point of view, they are enabling the enforcement of the Law but in essence, they are deficient since they do not prescribe appropriately the actions and procedures like, for example, the procedure for defining the relevant market. Also, some of the bylaws which are of key importance for the improvement of the Commission’s work have not been passed, like the Enactment on banned agreements which are exempt from the ban.

20. **Judiciary**, as the third branch of government, is of special importance for good governance, since this branch of government has, within the division of power, a control function over the other two branches of government, primarily over executive power. Moreover, the judiciary is one of the basic components of the rule of law as one of the key elements of good governance. The judiciary is faced with numerous assaults on its independence which is best seen in political struggles concerning the manner of appointing, or removing the judges. These struggles should also be seen in the light of inherited personnel structure in judiciary, the one that was to be found in judiciary bodies in 2000. On one hand, political parties, i.e. the legislative and executive power, wanted to control not only the election process but the candidacy of the judges and the initiation of the process of their removal to the greatest extent possible. Such control of the personnel issues would enable the ruling political parties to control this branch of government; in other words, it would jeopardize its independence. On the other hand, the dominance of the Great personnel council regarding the proposal process would provide that the judges themselves completely control the process of electing new colleagues. Thus, the basis for reproduction of dissatisfactory judicial personnel structure is created, as well as for avoiding the lustration process which was initiated several times. Moreover, there is a widespread opinion within the judicial system that the judicial independence means that judiciary is not accountable to anyone for its work.

21. During the 1990-ies the judiciary experienced a strong negative selection. Whereas during the one-party socialist system the judiciary had a certain reputation and the judges had a decent financial and social status, none of that remained with the introduction of a multiparty system and progress of the market economy. The degradation of reputation and relative income made many judges, the better ones mostly, to opt for a private practice where they could earn much more. Furthermore, the participation of judiciary in political, especially election manipulations, lessened their reputation. Such features of the personnel structure add a special element to consideration of the independence issue.

22. The organization of judiciary is not adequate. From the territorial organization aspect, a wide network of courts with a great number of judges was inherited. The number of judges is the same as in Argentina (with almost five times more people and a federal structure of the state), and six times more than in Denmark (a country with somewhat smaller population and 7.5 times bigger GDP). At the same time, there is a great backlog of cases. The main reason is because the judges are inefficient since there is no team work culture. In most of the cases the judge is "one man band", meaning he/she does all the additional tasks that the court clerks are supposed to do for him. The reasons for the lack of

cooperation can be found on both sides. Furthermore, regardless of the lack of this immediate cooperation, the quality of court clerks, to the extent to which they perform the tasks, in no way contributes to the efficiency of judiciary.

23. Many organizational changes in judiciary that were planned and stipulated by law have simply not been implemented. The administrative court, as a second instance court in the case of administrative proceedings, was not established and the burden was not taken from the Supreme Court regarding its present appeal function. That is why the Supreme Court, consisting of a great number of judges, cannot focus on its main functions and that is the improvement and provision of uniformity of judicial practice. Moreover, the Supreme Court is not active in advocacy of judiciary and its interests. Instead it is reduced to public exchange of accusations with the representatives of executive power, mostly through the media. The longstanding and consistent negation of the existence of corruption and other abuses in the judiciary after the unveiling of such cases, even in the case of a Supreme Court judge himself, did a lot of damage to the Supreme Court's reputation and the reputation of the judicial power as a whole.

24. The research showed that, from the beneficiary's point of view, inefficiency and incompetence are bigger problems of judiciary power than the corruption itself. A part of the inefficiency problem lies in inadequate process rules. The passing of new laws that simplify and accelerate the procedure resulted in significant progress regarding the judiciary efficiency (the average time for enforcing contractual compliance is reduced for more than 1/3).

25. The Government of Serbia adopted the National Judicial Reform Strategy. Independent of the content of the Strategy, which is a very general document, there is a feeling that it was adopted "under pressure" from the international factors and that the executive power itself had no strong political will to dedicate itself to this job. This is indirectly seen from the fact that two years after the adoption of this strategy very little has been done to implement it even though the strategy itself anticipates short-term measures that were supposed to be implemented by the end of the last year inclusive.

26. The basic dilemma regarding the improvement of administration through judicial reform is whether the political parties actually want the judiciary to reform. To great extent it depends on the political parties' goals i.e. whether strong, independent and efficient judiciary can contribute or hinder the fulfillment of those goals. It is to be expected that further stabilization of political party scene, its gathering into bulks, and extending the time horizons of political parties (lowering their discount rate) will create political incentives for judiciary reform in that

sense. Regarding the foreign issues, the process of approximation to the EU represents an additional incentive for such measures, both within the framework defined by the SAA and the framework that could potentially provide Serbia with the status of the candidate country for the membership.

27. **The level of corruption** in Serbia declined after the peak it probably reached in 2000. Independent research of the entrepreneurs showed that there was a decline not only in the spread of administrative corruption (measured by the number of corruption transactions) but in its intensity, too (measured by the average size of the bribe). Indirect state policies regarding the fight against corruption, primarily linked to the state policies in the area of liberalization and deregulation (prices, foreign trade etc.) as well as the state policies in the area of public procurement, diminished the incentives to the companies to act corruptively i.e. the incentives to the civil servants to obtain bribe by extortion or collusion.

Box 3 **The Anti-Corruption Council**

The Anti-Corruption Council is established as advisory body of the Government of Serbia with the mandate to “oversee the activities in the fight against corruption, to propose ... measures to be taken ... and monitor their implementation and give initiatives”. However, the activities of the Council so far have been directed towards specific cases of corruption and in those cases the Council took an investigative function. Moreover, the analysis of the cases the Council has chosen, show that the issue was not only the alleged corruption but different non-corruptive forms of law violations were considered, and in many cases certain state policies were examined (privatization policy, for example) from the aspect of their social relevance. Such deviations from the basic competence led to the conflict within the Council itself (a great number of people left this body) but it also led to the conflict with the founder – the Government of Serbia.

One of the main complaints of the Council regarding the founder was that the financing was insufficient and irregular but the justification of such a complaint can only be seen on the basis of a clear mandate and agenda. Even more so since there was an unresolved issue within the Council itself as to whether its members should work on voluntary basis or be paid for it. Certainly in a situation when high-quality associates have not been professionally engaged, it is not possible to obtain high-quality legal and economic analysis which is evident from the available Council's reports. The Council itself practically has no employees and to a great extent, everything comes down to voluntary work.

Obviously, the Council's work has not been accompanied by appropriate bylaws but the main problem originates from disrespect of the bylaw by which the Council was established. It is certain that the Council, as it is, has no future, but there is still the open issue of advisory function since the proposed solution for the Agency for Fight against Corruption does not cover that function.

28. There is no reliable data on political corruption developments (regardless of whether it is administrative corruption or state capture). Although the political parties gladly put this topic on their agenda and use it for political struggle, especially during the pre-election campaign, public opinion researches do not show that the corruption issue is of crucial importance for the voters, that is to say, they do not consider it to be the greatest social problem (it is ranked only at 4th place). Most probably the political parties estimated that this kind of insistence on corruption phenomenon (regardless of whether someone is in power or not) brings good results to political rating. Still, one should not make definite conclusions about the existence and degree of political corruption based on that.

29. Besides definitive success achieved regarding the indirect policies of fight against corruption, for direct measures the success was disputable. There was a lot of wandering about on that issue, especially as to whether the direct fight against corruption should be left exclusively to the “classic” bodies of state (police, prosecution, courts) or the new, specialized anti-corruption institutions should get more involved in that. While in the first period after the year 2000, the new specialized anti-corruption institutions were rather popular, the experience with the Anti-Corruption Council led to the turning towards the “classical” institutions, which were undoubtedly successful in the last couple of years in unveiling corruption hubs in the public administration (wrongly called “the mafias”).

30. The National Assembly adopted two key laws regarding the direct fight against corruption, political corruption above all, and those are the Law on Financing Political Parties and Law on Prevention of Conflict of Interest. Still waiting to be adopted is the proposal of the Law on the Agency for Fight against Corruption the mandate of which would be the implementation of exactly these two laws. The Law on Financing Political Parties is too restrictive, so all the political parties have an “alibi” not to implement it consistently while the penalty provisions of the Law on Prevention of Conflict of Interest are too mild. If the proposal of the Law on the Agency for Fight against Corruption is adopted, the mandate of the existing Anti-Corruption Council will cease, which means that even the nominal, advisory function of this body will be lost, that is, the executive power will no longer be in a position to receive institutionalized opinions on the possibilities for the fight against corruption.

Box 4
Public Procurement Office

Pursuant to the Public Procurement Law adopted in 2003 two new bodies were established, the Public Procurement Office and the Commission for the Protection of Bidders' Rights. The Public Procurement Office was established as a separate organization of the Government of the Republic of Serbia whose job was to establish a system of public procurement that will be economical, efficient and transparent and enable the strengthening of competition, equal treatment for all bidders and eradication of corruption. The Commission for Protection of Rights (formerly the Commission for the Protection of Bidders' Rights) was established with the aim to protect the rights of bidders and public interest in all the phases of the proceedings for the granting of public procurement agreement. Neither the Public Procurement Office nor the Commission may be considered as independent bodies, since the head of the Office, i.e. the members of the Commission are appointed by the Government. The proposal of the new Public Procurement Law that is to be adopted in the National Assembly of the Republic of Serbia changes the current solution considerably. Namely, the members of the Commission for the Protection of Bidders' Rights will be elected by the National Assembly at the Government's proposal.

Since the Law started being implemented there was an evident improvement regarding the transparency and competition compared to the period before the adoption of the Law. Competitive measures like publishing the public invitation and free competition among the bidders increased their share from 0 % in 2001 to 36% in 2002 in order to reach 73% in 2006.

However, there are many technical problems in the implementation. Namely, the area is very complex and the institutions in Serbia are not used to conducting procurement in line with the procedures prescribed in advanced. That is why there was a huge pressure on the Public Procurement Office in a sense that they were asked to explain and give advice but they did not have the capacity to fully respond to these demands. As an illustration of the problems facing the Office we mention the data from 2005: there were 80,000 bidders, 12,000 ordering parties and 250,000 agreements. There are around 25 employees in the Public Procurement Office and it is quite clear that the Office cannot deal alone with all the problems relating to the public procurement.

Overview of institutions

Established and operational institutions	Established but not quite operational institutions	Institutions stipulated by law but not yet established	Institutions that are necessary but not yet provided by legal regulations
<p>Securities Commission</p> <p>Commission for Protection of Competition</p> <p>Energy Agency</p> <p>Republic Broadcasting Council</p> <p>Republic Telecommunications Agency</p> <p>Medicines and Medical Devices Agency</p> <p>Anti-Corruption Council</p> <p>Commissioner for Information of Public Importance</p> <p>Republic Committee for Resolving Conflict of Interests</p> <p>Public Procurement Office</p> <p>Commission for the Protection of Bidders' Rights</p> <p>Chamber of Certified Auditors</p> <p>National Accounting Commission</p>	<p>State Audit Institution</p> <p>Railroad Directorate</p>	<p>Postal Service Agency</p>	<p>Agency for Agricultural Payments</p> <p>National Food Control Laboratory</p> <p>Agency for Fight Against Corruption</p>