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ECONOMIC REFORM PROGRAMME

OF

SERBIA
(2020-2022)

COMMISSION ASSESSMENT

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The Economic Reform Programmes (ERP) were submitted around end-January 2020 and the present Commission assessment was finalised shortly thereafter in February 2020, supported by a fact-finding mission in mid-February.

The Covid-19-related economic crisis has in the meantime rendered the macro-fiscal scenarios presented in the ERP and in the Commission assessment largely obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the Covid-19 crisis, in its spring economic forecast in early May 2020.

While the short-term macro-fiscal outlook has profoundly changed, the present Commission assessment also identifies structural reform challenges and priorities, including in the area of fiscal governance, which remain largely valid. Addressing these structural issues will be essential to ensure a sustained economic recovery after the crisis. The Joint Conclusions to be adopted at the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey will accordingly focus this year on the short-term priorities to mitigate the socio-economic consequences of the Covid-19 crisis and on the medium-term priorities to strengthen the foundations of a sustained recovery thereafter. While the Commission assessment does not address weaknesses in the public health system and issues in the social protection system are assessed only as far as they are linked to the key structural challenges, these two areas will feature more prominently among the issues identified in the policy guidance.

Contents

1. EXECUTIVE SUMMARY

The economic reform programme's baseline projection of continued robust economic growth seems broadly plausible, but faces downside risks. 2019 turned out better than expected, as strong domestic demand maintained GDP growth above 4% for the second consecutive year. Under the economic reform programme (ERP), the economy is forecast to continue expanding steadily at 4.0% annually in 2020-2022, supported by sound growth in private consumption, investment and exports. However, short-term economic prospects remain subject to downward risks. In particular, the ERP's projection of gradually narrowing current account deficits looks optimistic, given the slowdown of external demand, international trade tensions, the already large export base and the strong import dependence of foreign direct investment (FDI) so far. The financial sector has remained sound, while there has been further progress with reforming and privatising state-owned financial institutions.

The fiscal strategy projects a slow reduction of government debt to below 50% of GDP through broadly balanced budgets, with only gradual steps towards a more pro-growth orientation of public finance. Supported by strong revenue performance, the general government budget remained close to balance in 2019, despite substantially increased expenditure compared with the original budget. Growth-enhancing measures in the 2020 budget have remained modest, as most of the fiscal space for 2020 had already been used by the 2019 amending budget, which increased wages above nominal GDP growth for the third consecutive year. While capital spending is projected to increase gradually over 2020-2022, further increases in line with the higher 2019 outturn could help address investment needs. Government debt is expected to fall further, although more slowly. While economic risks remain significant, government debt remains relatively high and subject to vulnerabilities. Significant unaddressed gaps in fiscal governance remain.

The main challenges in these respects include the following.

- **Although Serbia continues to achieve good macro-fiscal results, the reform process needs to recover its lost momentum and fiscal results need to be anchored by a credible framework.** The baseline scenario appears broadly realistic, but faces major risks. Effective implementation of some major outstanding public sector reform initiatives, such as reform of the wage system, and faster progress with the public administration reform, could help ensure that the macro-fiscal results achieved are lasting ones. Since fiscal performance has been vulnerable and sensitive to the economic and political cycle over the last two decades, tightening up fiscal rules could provide lasting guidance to public finances and help institutionalise sound fiscal policies.

- **There is further scope to increase capital spending, enhance transparency on fiscal risks and to improve the performance of state-owned enterprises.** The containment of current spending is required in order to reallocate resources to investment in education, health, transport and the environment. Increased transparency on fiscal risks could also contribute to better reduce them, in particular as regards state-owned enterprises. The incomplete restructuring and unfinished privatisation of state-owned enterprises indeed still represent a substantial risk to public finances.

- **The business environment has improved, but is still held back by red tape, political interference and a lack of predictability in the implementation of legislation.** The outsized state-owned enterprises crowd out private sector development. Foreign direct investment (FDI) often receive generous public support, while other firms, in particular domestic small and medium-sized enterprises (SMEs), are left in a less favourable position. Access to finance has improved, but own resources remain the main source of funding for SMEs. The informal sector is still sizeable and poses a challenge in terms of unfair competition from unregistered companies. Unpredictability and lack of sufficient stakeholder consultations on new regulations on business-related matters remain an issue.

- **Serbia's competitiveness continues to be hampered by a polluting and inefficient energy sector that is not properly regulated.** The restructuring of state-owned enterprises in the energy sector is facing delays, posing a risk to public finances. Electricity prices are not high enough for costs to be recovered. This holds back further investment needed to make the energy sector more efficient and cut carbon emissions. Investment in the energy sector agreed through non-transparent inter-governmental agreements raises serious concerns.

- **The fact that a relative low proportion of young people and women are integrated in the labour market continues to be the key labour market challenge.** At the same time, the emigration of workers across the occupational spectrum hampers Serbia's growth potential. The government has adopted fiscal measures to stimulate circular migration but these have so far had little perceptible impact. Another issue is the substantial informal economy, especially in the areas of agriculture, construction and domestic services. Finally, the tax wedge for workers with a low end income remains too high.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2019 has been partially implemented. The 2019 budget remained close to balance, while the 2020 budget and the medium-term fiscal strategy also continue to target a broadly balanced budget. The indexation formula for pensions, if applied in the long term, should contain pensions as a percentage of GDP. At the same time, high discretionary rises in public sector wages are set to increase wage expenditure as a proportion of GDP for the third consecutive year. Moreover, the reform of the public sector wage system has been postponed by another year. There was some strong growth in capital spending in 2019, although to a large extent this reflected a surge in security spending (military, police). There are too many exceptions in the new legislative framework for public investment management, leading to persistent issues of transparency, evaluation and prioritisation. No measures were taken in 2019 to strengthen the fiscal rule framework. Serbia finalised a Smart Specialisation Strategy, adopted a new Industrial Policy Strategy and introduced needed legislation on the alternative investment vehicles. The process of consultation for new legislation has only partially improved. Governance issues and restructuring in the energy sector remained to a large extent unaddressed. Electricity prices remain insufficiently high to reflect the actual costs. Little progress has been made in reducing the high non-wage labour cost of jobs at the lower sections of the wage distribution. There were no measures on the formalisation of labour in non-agricultural sectors and the funding for Active Labour Market Policies was not increased.

The ERP is aligned in part with the reform priorities identified by the Commission. The macroeconomic and fiscal frameworks are sufficiently comprehensive and integrated with the overall policy objectives, providing an adequate basis for policy discussions. However, the alternative scenario may seem somewhat too optimistic. The part covering structural reforms remains largely unchanged from the previous year, reflecting delays in implementation. It appropriately continues with measures to modernise energy infrastructure and boost energy efficiency investments. It also brings, for the first time, a reform measure on the circular economy. The diagnostic presented in the ERP for education, employment and social policies is relevant, while the proposed measures in the areas of employment and social protection are either vague or do not remedy the fundamental challenges, lacking the clearly defined objectives.

2. ECONOMIC OUTLOOK AND RISKS

The ERP has maintained its baseline projection of robust economic growth largely unchanged from the previous programme, which remains broadly in line with the Commission's autumn forecast. Economic growth in 2019 turned out better than expected; strong domestic demand effects, in particular from investment, kept real GDP growth above 4% for the second consecutive year. The baseline scenario predicts that the economy will continue to expand at a steady pace of 4.0% in 2020-2022, thanks to continued sound growth in private consumption, investment and exports. Although the trade balance deteriorated further in 2019, export growth is projected to outpace imports as of 2020, resulting in a balanced net export contribution to growth as of 2021. On the supply side, the programme is based on the expectation that growth will be driven by services, industry and construction. Following the closure of the negative output gap in 2018, the ERP forecasts that the output gap will remain slightly positive in the medium term, with the rate of potential growth estimated at similar levels as expected real growth rates. Steady economic expansion is expected to further boost employment and cut the unemployment rate to below 10% as of 2021.

Some aspects of the macro scenario seem more open to doubt, given existing downside risks. The main issue here is the projected reduction of external imbalances. Export projections may still appear relatively optimistic, in view of the economic slowdown experienced by Serbia's main trading partners. Moreover, the expectation of a continued robust export performance is based mainly on FDI in tradable sectors. However, recent experience shows that the net contribution of new export capacities to reducing external imbalances is typically constrained by a major import component. Although recent substantial FDI has extended Serbia's production and export base, more prudent export projections are warranted. The reasons for this are the slowdown in external demand from the country's main trading partners, international trade tensions, and the fact that the export base is already sizeable. On the other hand, Kosovo's prohibitively high tariffs on imports from Serbia, even if maintained, will no longer weigh on export growth as of 2020. As regards imports, in addition to the high import content of FDI-based exports, the positive output gap, rising investment and expansionary fiscal policy are all likely to maintain import growth at high levels and are thus probable impediments to the projected narrowing of external imbalances. Moreover, recent investment growth in the construction sector has been strongly supported by large-scale infrastructure projects (notably the Serbian section of the Turkstream gas pipeline in 2019). It may not be easy to replace these by projects on a similar scale with the capacity to underpin growth rates to the same extent over 2020-2022.

As regards potential growth, there does not seem to be sufficient justification for the projected strong increase in the contribution of total factor productivity to potential growth rates as of 2020, given the recent lower track record under similar conditions. This suggests that there is a risk of the positive output gap over 2020-2022 widening further, rather than stabilising, as projected. Real growth might, accordingly, be constrained at some point by limitations in potential growth, while the potentially larger positive output gap would imply higher structural fiscal deficits at the same relatively low headline deficits.

Table 1

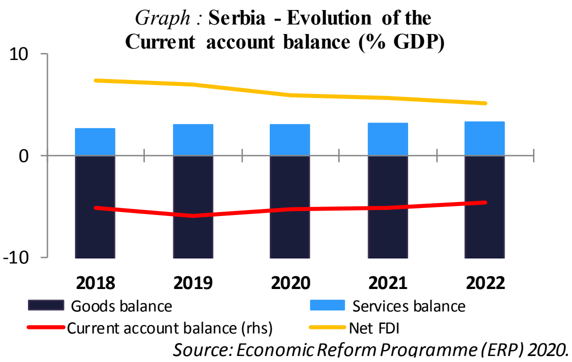
Serbia - Comparison of macroeconomic developments and forecasts

	2018		2019		2020		2021		2022	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	4.4	**4.4**	3.2	**3.5**	3.8	**4.0**	3.7	**4.0**	n.a.	**4.0**
Contributions:										
- Final domestic demand	5.9	**6.2**	4.7	**5.0**	4.5	**4.4**	4.5	**4.0**	n.a.	**3.9**
- Change in inventories	0.9	**0.8**	0.0	**0.0**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	-2.4	**-2.6**	-1.5	**-1.5**	-0.7	**-0.4**	-0.8	**0.0**	n.a.	**0.0**
Employment (% change)	1.4	**1.4**	1.8	**2.0**	1.2	**1.2**	1.2	**1.0**	n.a.	**1.0**
Unemployment rate (%)	12.7	**13.3**	10.5	**11.2**	8.9	**10.2**	7.2	**9.5**	n.a.	**8.7**
GDP deflator (% change)	2.1	**2.1**	2.4	**3.3**	2.4	**3.4**	2.5	**3.4**	n.a.	**3.5**
CPI inflation (%)	2.0	**2.0**	2.1	**1.9**	2.1	**2.0**	2.1	**2.2**	n.a.	**2.5**
Current account balance (% of GDP)	-5.2	**-5.2**	-6.0	**-5.9**	-5.5	**-5.3**	-5.5	**-5.2**	n.a.	**-4.7**
General government balance (% of GDP)	0.6	**0.6**	-0.1	**-0.5**	-0.5	**-0.5**	-0.5	**-0.5**	n.a.	**-0.5**
Government gross debt (% of GDP)	54.5	**54.4**	52.1	**52.9**	49.9	**51.4**	48.0	**50.1**	n.a.	**48.3**

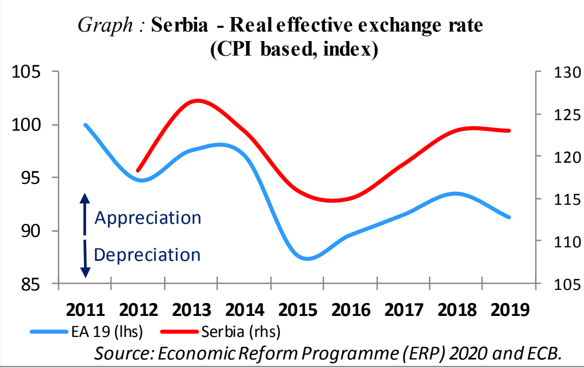
Sources: Economic Reform Programme (ERP) 2020, Commission Autumn 2019 forecast (COM); COM forecast does not take into account the latest national account revision.

The ERP presents a clear view of economic risks and uncertainties, including a detailed alternative macroeconomic scenario. The programme acknowledges that external risks are rather tilted to the downside, associated with fluctuations in commodity prices and financial markets, the divergent monetary policies of major central banks, and trade tensions. Domestically, the main risks it outlines are associated with the volatility of agricultural production and the pace of implementation of public investment projects and economic reforms, particularly of state-owned enterprises in the energy sector. Overall, the programme considers internal risks to be mildly tilted to the upside if reforms of SOEs in the energy sector are implemented faster than projected in the programme's baseline, or if a new model is introduced in the automotive industry accumulator factory in Sombor (*FAS*). However, the recent track record of continual delays in the reform of SOEs, especially in the energy sector, suggests that the assumption of a positive risk in this area may be over-optimistic, partly because the programme has no further components that would suggest a potential positive risk. The programme presents an alternative macroeconomic and fiscal scenario, projecting lower economic growth (by 1.5 pps on annual average over the three years) and worse fiscal performance in the event of faster growth in private consumption, a slowdown in investment activity, and a stronger slowdown in external demand. While the underlying assumptions are clearly detailed and quantified, the alternative scenario may still seem rather optimistic, given the potential magnitude of underlying risks associated with the external environment and potential growth, and historical experience from before the recent phase of macroeconomic stability. These considerations tend to make it less relevant in terms of risk management.

Inflationary pressures have been low and price stability appears to be well anchored, despite robust domestic demand. Consumer price inflation has remained low and quite stable for several years. In 2019, it averaged 1.7%, remaining mostly below the mid-point of the central bank target tolerance band of 3% ± 1.5 pps throughout the year. The central bank lowered its key policy rate in three steps of 25 basis points each in that year, to 2.25%. Given the importance of the exchange rate for the price-setting behaviour of economic agents and financial stability, the central bank continued its frequent and sizeable interventions on both sides of the foreign exchange market, buying a net EUR 2.1 billion in 2019. The ERP predicts a slight increase in inflation towards the midpoint of the target band by 2022, which appears reasonable. Food and regulated prices are liable to continue to influence short-term price dynamics, while growing aggregate demand is likely to be the main factor pushing up inflation during the programme period. The projected stability of the dinar exchange rate is likely to help contain inflation within the target range.



Source: Economic Reform Programme (ERP) 2020.



Source: Economic Reform Programme (ERP) 2020 and ECB.

External imbalances have widened further, and views on their future development diverge. Contrary to the expectations in last year's programme, import growth continued to exceed export growth in 2019, widening the trade deficit to 12.3% in that year, while the current account deficit increased to 6.9% of GDP. The authorities believe that external imbalances have peaked and will already start to decrease in 2020, with the current account deficit gradually narrowing to 4.7% of GDP by 2022. This expectation is based on the projection of a continued robust export performance, supported by FDI in tradable sectors. However, this view seems rather favourable in view of high import contents, the slowdown in external demand, and an already large export base. Moreover, the baseline scenario of growing domestic demand should also trigger further strong import growth, while primary income outflows are set to increase in line with the rising stock of foreign investment.

Large FDI inflows, which have continued to fully cover the current account deficit, remain essential for external sustainability and to boost competitiveness. Net FDI inflows have ensured sound financing of the external deficit. Continuously exceeding 5% of GDP per year over the last five years, they increased to around 7% in 2018 and 2019, and have thus continued to more than cover the current account deficit. FDI inflows have also been crucial for the ongoing structural transformation of the economy towards tradable sectors. The stock of FDI has increased by almost 70% since 2013, and reinvested earnings have more than tripled their share in total FDI, all of which shows that the country remains an attractive destination for investment. Foreign investors also benefit from generous incentives such as direct cash subsidies, tax breaks and various forms of in-kind governmental support, primarily land and infrastructure. Thus, the programme's assumption of continuing strong FDI inflows over the next few years appears plausible, provided that macroeconomic stability continues, economic reforms continue to be pursued and the business environment is further improved. Over the last six years, the stock of net FDI has also increased its share in Serbia's net international investment position from around two thirds to close to 90%. Since FDI can be considered a relatively stable source of funding, this trend has reduced vulnerabilities to external shocks, despite a persistently high net foreign liability position of close to 90% of GDP. Another factor that might cushion external shocks is the relatively high level of foreign exchange reserves, which have consistently covered around six months' worth of imports and are expected to remain at an adequate level during the programme period.

The financial sector has been supportive of growth and its performance is sound, while there has been further progress with privatisation and reforms of state-owned financial institutions. The capital adequacy, liquidity and profitability indicators of commercial banks have remained high. Favourable financing conditions and labour market developments supported credit growth in 2019. Lending to households and corporates increased at close to double-digit rates, excluding the effects of exchange rate fluctuations and non-performing loan (NPL) sales and write-offs. Although the central bank does not consider the overall credit level excessive, it took steps to curb the build-up of risk by limiting credit growth in some market segments, such as household cash loans with long maturities. The completion of the 2015-2018 NPL resolution strategy and the launch of the 2018-2020 NPL resolution programme delivered good results, with NPLs declining from a peak of close to 22% in 2015 to 4.1% in 2019. Reforms to reduce the still sizeable state presence in the sector and improve the governance of state-owned banks have also advanced substantially, most importantly via the agreement reached in February 2020 on the sale of *Komercijalna Banka,* Serbia's third-largest bank by assets.

Table 2

Serbia - Financial sector indicators

	2015	2016	2017	2018	2019
Total assets of the banking system (EUR million	35 655	36 992	37 676	41 514	46 060
Foreign ownership of banking system (%)	76.1	76.7	76.9	75.4	76.6**
Credit growth	2.9	2.5	1.9	9.4	9.1
Deposit growth	6.5	11.4	3.3	15.3	8.5
Loan-to-deposit ratio	1.10	1.00	1.00	1.00	0.96
Financial soundness indicators					
- non-performing loans	21.6	17.0	9.8	5.7	4.7**
- net capital to risk-weighted assets	20.9	21.8	22.6	22.3	23.6**
- liquid assets to total assets	40.5	38.9	35.1	35.7	35.9**
- return on equity	1.5	3.3	10.5	11.3	10.5**
- forex loans to total loans* (%)	72.3	69.4	67.5	68.5	66.9**

* Includes both denominated and indexed positions.

Note: Data for December 2019 are preliminary.

** September 2019

Sources: ERP 2020, National Central Bank.

3. PUBLIC FINANCE

Strong revenue performance enabled Serbia to increase spending substantially in 2019 while continuing to abide by its original deficit targets. Strong revenue performance created additional fiscal space to boost spending by around 1.8% of GDP as compared to the original 2019 budget plan. The final 2019 deficit came to 0.2% of GDP, somewhat lower than the initial target of 0.5% of GDP. As regards tax revenue, positive labour market developments and increased corporate profits boosted revenue from social contributions, personal income tax and corporate income tax, while VAT revenue increased in line with disposable income. Compared to the original budget, the 2019 revenue outturn outperformed the original budget targets, in particular for social contributions (+0.5% of GDP), personal income tax (+0.3% of GDP), excise duties (0.3% of GDP) and value added tax (0.2% of GDP). Non-tax revenue also contributed to revenue over-performance, in particular via central bank profit and dividend payments. It was planned that the additional revenue would mostly be used for current spending, in particular to cover one-off costs (in particular for the conversion of Swiss franc housing loans (0.2% of GDP) and a one-off pension bonus payment (0.2% of GDP), higher personnel costs (0.3% of GDP) in line with the additional salary increase by an average 9.6% as of December (following a 9.0% average increase in the initial 2019 budget), and higher purchases of goods and services, in particular at local level. Wages rose faster than nominal GDP for the second consecutive year in 2019. While in autumn only around a quarter of additional spending was planned to be used for additional capital spending, high advance payments in December brought the share of additional capital spending (0.9% of GDP) to around half of total additional spending, as compared with the original 2019 budget. Overall, capital spending as a percentage of GDP rose by 1.0 pp. compared with 2018.

Table 3

Serbia - Composition of the budgetary adjustment (% of GDP)

	2018	2019	2020	2021	2022	Change: 2019-22
Revenues	41.5	41.4	40.2	39.4	38.7	-2.7
- Taxes and social security contributions	36.0	36.5	35.8	35.4	34.9	-1.6
- Other (residual)	5.5	4.9	4.4	4.0	3.8	-1.1
Expenditure	40.9	41.9	40.7	39.9	39.2	-2.7
- Primary expenditure	38.8	39.8	38.8	38.2	37.6	-2.2
of which:						
Gross fixed capital formation	3.9	4.4	4.5	4.6	4.7	0.3
Consumption	16.0	16.5	16.3	16.2	16.1	-0.4
Transfers & subsidies	16.9	17.1	16.2	15.7	15.3	-1.8
Other (residual)	2.0	1.8	1.8	1.7	1.5	-0.3
- Interest payments	2.1	2.1	1.9	1.7	1.6	-0.5
Budget balance	0.6	-0.5	-0.5	-0.5	-0.5	0.0
- Cyclically adjusted	0.5	-0.6	-0.6	-0.6	-0.6	0.0
Primary balance	2.7	1.6	1.4	1.2	1.1	-0.5
- Cyclically adjusted	2.7	1.5	1.4	1.1	1.0	-0.5
Gross debt level	54.4	52.9	51.4	50.1	48.3	-4.6

Sources: Economic Reform Programme (ERP) 2020.

The ERP's medium-term fiscal strategy remains prudent, but only moderately increases its growth orientation. The programme sets the medium-term budgetary objective at the same level as in the last two years, at a deficit of 0.5% of GDP. This deficit is considered sufficient to ensure fiscal sustainability and further debt reduction to below 50% of GDP within the programme period. It does not allow for any obligations that could arise from the need to return or provide compensation for property confiscated by communist authorities after World War II. The fiscal objectives are also broadly in line with last year's policy guidance to target a budget close to balance in the medium term. Both revenue and expenditure ratios are set to decline at the same pace over 2020-2022. Overall spending on wages as a proportion of GDP remains unchanged at the 2019 level of 9.5% throughout the programme. The programme includes no estimates of the cost of reforming the public wage system, planned for 2021. Pension expenditure as a proportion of GDP is projected to fall by 0.2 percentage points annually, reaching 9.8% in 2022. While capital expenditure is set to increase gradually by 0.1 percentage points annually from the ERP estimate of 4.4% in 2019 to 4.7% of GDP in 2022, this would still represent a decline from the 2019 outturn of 4.9% of GDP, although that was influenced to some extent by a peak in security spending.

The 2020 budget is set to remain broadly balanced but will promote long-term growth to a moderate extent only. The planned fiscal policy stance is slightly pro-cyclical, aiming at a consolidated deficit of 0.5% of GDP. This would result in a slight deterioration of the cyclically-adjusted primary balance by 0.2% of GDP according to the ERP (and of about ½% of GDP as compared to the 2019 outturn). The authorities expect a decline of 1.2 percentage points in both total revenue and total expenditure as a proportion of GDP. The reduction on the revenue side is expected to be mainly associated with non-tax revenue (as a result of abolishing the remaining public sector wage cuts, the savings from which were transferred to the state budget until 2019), excise duties (related to conservative assumptions about the related volumes) and corporate income tax (partly due to tax benefits for banks in connection with the Swiss franc loan conversions). Revenue projections can be considered conservative; although further gains in the efficiency of tax collection are expected, forecasts take no explicit account of any possible gains from measures to combat the informal economy. The revenue-reducing impact of the measures to reduce taxes and other contributions due on wages (i.e. the 0.5 percentage point reduction in social security contributions and the increase in the personal income tax allowance) is expected to be fully offset by favourable developments in employment and wages.

Developments in planned expenditure are partly a reflection of policy changes, particularly the carry-over effect of the wage increases (by an average 9.5% as of December 2019) adopted in the October 2019 amending budget. Expenditure on social benefits is planned to decline in percentage of GDP thanks to the growing economy and employment and the increase of pensions below nominal GDP growth, reflecting the impact of the new Swiss formula for pension indexation (50% net wage growth and 50% inflation) as of 2020. The decrease in indebtedness and lower interest rates are expected to reduce interest payments further, by 0.2 percentage points of GDP in 2020. Compared with the initial budget for 2019, the budget now provides for a small increase in capital spending (by 0.1% of GDP to 4.5% of GDP). This represents a 0.4 percentage point reduction as compared to the 2019 outturn. Overall, as a large part of the fiscal space had already been used for the large increases in wage expenditure resulting from the carry-over effect of the 2019 amending budget, the 2020 budget takes only moderate steps towards boosting long-term growth via a relatively modest reduction in tax and other contributions due on wages (the 'tax wedge') and some increase in productive capital spending.

The 2020 budget

Parliament adopted the 2020 national budget on 28 November 2019.

The general government deficit target for 2020 is 0.5% of GDP, which implies a slight fiscal policy easing. On the revenue side, the main policy measures are the total abolition of wage cuts in state-owned enterprises and, consequently, an end to transferring the resultant savings to the budget, a reduction in employers' contribution to pension insurance, an increase in the personal income tax allowance and a rise in the hourly minimum wage. The main new expenditure measures are the carry-over effect of the selective wage increases decided in the 2019 amending budget, and higher capital spending.

Main measures in the 2020 budget*

Revenue measures	**Expenditure measures****
• Reduction by 0.5% of the pension insurance contribution paid by employers **(-0.2 % of GDP)** • Lifting of the remaining half of the wage cuts in state-owned enterprises (**0.2% of GDP**) • Increase in personal income tax allowance from RSD 15 300 to RSD 16 300 (-**0.1% of GDP**) • Increase in minimum wage **(+0.2% of GDP)**	• Increase in capital expenditure **(0.1% of GDP)**
Total revenue effect (-0.3% of GDP)	**Total expenditure effect (0.1% of GDP)**

* Estimated impact on general government revenue and expenditure.

** The table does not include the main expenditure impact corresponding to the carry-over effect (0.8% of GDP) from the December 2019 wage increases as these had already been adopted in the October 2019 amending budget.

Source: ERP 2020

The decline in government debt and debt servicing costs, which has been significant in recent years, is expected to continue. The ERP forecasts that government debt will continue to decline, albeit at a significantly slower pace of around 1.5 percentage points annually, to 48.3% of GDP in 2022. Yields on government bonds and the country risk premium have declined markedly over recent years and are set to fall further under the baseline macroeconomic scenario. The robust macro-fiscal outcomes and successive credit rating upgrades should help to further reduce debt-servicing costs. The programme projects a fall in interest expenditure to 1.6% of GDP in 2022, almost a 50% drop from its 2015 peak. In 2019, the primary surplus and the snowball effect, capturing the difference between interest payments and nominal GDP growth, made roughly equal contributions to debt reduction. However, they were partially offset by positive stock-flow adjustments. These are expected to continue slowing down the reduction in the debt-to-GDP ratio by an annual average of 1.5 percentage points over 2020-2022. These stock-flow adjustments are not further specified, but rather reflect the overall relatively conservative stance of the medium-term debt projection. The programme's debt sensitivity analysis indicates that the debt-to-GDP ratio is likely to be particularly sensitive to appreciations or depreciations of the national currency resulting from the foreign currency share of nearly 75%.

Box: Debt dynamics

The government debt to GDP ratio fell by 1.5% of GDP in 2019. The decline was due to the primary surplus and the effects of real growth and inflation which more than offset interest expenditure and debt-increasing stock-flow adjustments. Looking ahead, the programme forecasts that the stock flow adjustment and interest expenditure will remain the only debt increasing factors. However, government debt is expected to decline further, albeit at a moderate pace, thanks to overall sound fiscal policy and steady economic growth. Restitution-related debt and fluctuations in government financial assets, not included in the baseline scenario, could also significantly drive up the debt-to-GDP ratio (by around five percentage points for the financing of restitutions, while revenue or expenditure from sales or acquisitions of financial assets can have both upward and downward impacts).

Table 4

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

	2018	2019	2020	2021	2022
Gross debt ratio [1]	**54.4**	**52.9**	**51.4**	**50.1**	**48.3**
Change in the ratio	-4.3	-1.5	-1.5	-1.3	-1.8
Contributions [2]:					
1. Primary balance	**-2.8**	**-1.6**	**-1.5**	**-1.2**	**-1.1**
2. "Snowball" effect	**-1.5**	**-1.5**	**-1.8**	**-1.9**	**-2.0**
Of which:					
Interest expenditure	2.1	2.1	1.9	1.7	1.6
Growth effect	-2.5	-1.8	-2.0	-2.0	-1.9
Inflation effect	-1.2	-1.7	-1.8	-1.7	-1.7
3. Stock-flow adjustment	**0.0**	**1.6**	**1.8**	**1.8**	**1.3**

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

[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).

The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

Source: Economic Reform Programme (ERP) 2020, ECFIN calculations.

Government debt remains relatively high and subject to vulnerabilities. Under the programme's baseline scenario, the public debt-to-GDP ratio would still be almost double the level it had reached before the 2008 global financial and economic crisis. In the years following the crisis, budget performance was easily derailed and fiscal sustainability deteriorated quickly. Gross financing needs remain high at nearly 10% of GDP and the large proportion of foreign currency-denominated debt (almost 75%) continues to expose government debt to the risk of potentially significant fluctuations, caused by exchange rate movements. In the absence of a sufficiently strong rules-based framework capable of effectively anchoring fiscal policy, ensuring debt sustainability will remain a major policy challenge. This means it is even more important for the authorities to strengthen fiscal rules, as planned, to make them more binding and relevant to policymaking.

Fiscal risks and uncertainties are non-negligible. Despite overall broadly balanced fiscal results supported by strong revenue buoyancy, the implementation of fiscal-structural reforms has been slow and much of the reform agenda remains uncompleted. No action has been taken to tackle known systemic weaknesses, such as the public hiring freeze mechanism and the rather opaque public wage system, the planned reform of which has been postponed by another year, or inadequate and inefficient capital spending. There remain major fiscal challenges related to the performance of state-owned enterprises and financial institutions, public-sector employment and wage policy, and the overall fiscal governance framework. Some of the major recent fiscal measures, such as substantial wage hikes exceeding nominal GDP growth in three consecutive years, are also hard to justify and have used up the available space for more productive expenditure. As in previous years, the programme fails to mention possible restitution-related obligations of up to EUR 2 billion or around 4% of GDP. The deadline for issuing government debt to cover these obligations had already been postponed from 2018 to December 2021. Another significant fiscal risk concerns decisions by domestic and foreign courts resulting in fines and damages payable by government bodies.

The Ministry of Finance has recently expanded its capacity to analyse fiscal risks and assess public-private partnerships, notably by setting up a special fiscal risk department. However, this department is still at an early stage of its operations. It could benefit from increased resources and, possibly from extending its scope beyond purely financial matters to include broader economic analysis. The authorities also took steps to improve the capital budgeting process and work progressed on strengthening the tax administration.

The breakdown of public revenue and expenditure is set to make moderate progress towards stronger pro-growth orientation. The programme forecasts that both revenue and expenditure will gradually decrease as a share of GDP by an annual average of 0.9 pps over 2020-2022. On the expenditure side, the decrease reflects relatively moderate projected growth rates of current primary expenditure below the growth of nominal GDP, while the ratio of growth-enhancing capital expenditure to GDP is set to increase moderately by 0.1 pp. annually. Given that several items of expenditure have recently seen substantial increases exceeding nominal GDP growth, it looks as if it will be difficult to keep future increases to the moderate level planned. As regards capital spending, the gradual increases appear moderate in view of the 2019 outturn. Although a new legislative framework for public investment management was introduced in 2019, there are still issues of transparency, prioritisation and evaluation of investment, and there are too many exceptions to the rule. Interest expenditure is set to decline by around 0.2 pps annually, in line with improved financing conditions. On the revenue side, the projections are mostly based on prudent estimates of trends in excise duty, corporate income tax and non-tax revenue. The projections also allow for a moderate impact of the growth-friendly reduction of personal income tax and social security contributions ('the tax wedge'). However, it is expected that this will be more than offset by overall employment growth and a continuing shift from informal to formal employment.

While there have been improvements in the institutional implementation of the budgetary process, the work on revision of fiscal rules has largely stalled. The overall institutional environment associated with the budget process has seen some improvements. The Fiscal Strategy was adopted in spring and there has been broad compliance with the budget calendar for the 2020 budget. There was a meaningful parliamentary debate on the 2020 budget and the authorities submitted the final annual budget execution reports for 2002-2018 to Parliament. However, work on revising fiscal rules has largely stalled. The existing fiscal rules remain weak and detached from the policy process. Moreover, they do not provide for appropriate penalties for non-compliance or for effective enforcement mechanisms. While the rule on the fiscal deficit has been complied with in recent years, and debt has gradually declined towards the defined ceiling, wages and pensions have been updated in line with ad hoc accretions to the budget system law. The new indexation formula for pensions entered into force in 2020. However, in and after February 2020 the authorities suggested in several public announcements that this rule could be adjusted to allow for higher pension increases. The planned wage system reform has been postponed for another year to 2021. The well-established Fiscal Council has been able to operate appropriately. There has been some improvement in the timeliness of budgetary statistical information. However, budget execution reports still lack information about large one-offs.

4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Serbia has been gradually restructuring its economy, mainly by investing in the tradable sector. Exports have been a major driver of growth. Manufacturing has modernised and diversified in recent years, but traditional industry, notably the energy sector, has not undergone restructuring. Its underperformance negatively affects economic growth. Moreover, to reach higher growth rates, better use needs to be made of the opportunities offered by the internal market and services, through ensuring a level playing field for all companies. Economic growth and improvements in living standards towards EU levels will thus depend on continuous implementation of structural reforms across many sectors.

The Commission has conducted an independent analysis of Serbia's economy and identified the main structural challenges to competitiveness and inclusive growth, drawing on Serbia's own ERP and other sources. The analysis highlights a number of structural challenges across many sectors. The three main ones are: (i) increasing employment of women and young people, (ii) strengthening the regulatory environment, and (iii) greening Serbia's energy sector and fully opening up the energy market.

Key challenge #1: Increasing employment of women and young people

Positive trends in the labour market continued in 2019 in line with the overall economic growth. The employment rate (20-64) increased in 2018 to 63.1% and continued to rise in 2019 following the positive macroeconomic trend. The labour force participation rate (15-64) rose further to 68% in 2019. In line with the positive economic trends, the unemployment rate (above 15 years) decreased by 1.8 pps year-on-year to 9.5% in Q3/2019. The long term unemployment rate went down by 1.6 pps year-on-year in Q3/2019.

Despite recent positive developments on the labour market, the fundamental challenges remain: the skills mismatch in the labour force and the unused potential of the economically inactive people, notably women and young people. This is situation is exacerbated by negative demographic trends with an ageing society and de-population owing to a negative migration balance.

Young people continue to face difficulties in entering the labour market. The proportion of people (not in employment, education and training) in the 20-34 age group stood at 24.1% in 2018, still significantly above the EU average (16.5%). The NEET rate for women is considerably higher than for men. Employment rates of recent graduates improved slightly in 2018 (up 2.4 pps compared with 2017), but are still much lower in Serbia (64.2%) than in the EU-28 (80.6%). At 26%, youth unemployment was 11.5 pps higher than in the EU (14.5 in Q3 2019).

Serbia is considering bringing in the Youth Guarantee (YG), which has proven to be an effective remedy to youth unemployment in the European Union. The YG provides a framework for tackling youth unemployment and inactivity and guarantees every young person below 25 years old a good quality offer of employment, continued education, apprenticeship or traineeship within a period of four months of becoming unemployed or leaving formal education. To function properly, the Youth Guarantee needs to be supported by effective hiring incentives and be based on strengthened public employment services, which provide career guidance, internships and structural reforms. It is included in the ERP as *Reform Measure 20 (National Employment Policy Improvement in line with EU good practice and standards)*. An analysis of the conditions needed to launch the Youth Guarantee is one of the elements of the reform measure. It also contains the preparation of a new National Employment Strategy 2021-2026. The adoption of a strategy is a starting point, but the reform measures need to be designed with a more comprehensive and strategic view. Serbia might as well consider the potential of social media and dedicated web-sites to reach out to inactive young people.

The gender gap is persistent, most notably as regards unemployment and economic inactivity rates. The employment rate (20-64) of women was 55.8% in 2018 compared with 70.5% for men. The underlying reasons include lack of childcare and lack of services providing care for the elderly, plus social conventions.

Active labour market policies (ALMP) to help the most vulnerable unemployed people in finding jobs remain underfunded and inadequate. The 2020 ALMP allocation of the Public Employment Service fell by 7.5%, while the number of contracts for carrying out the local employment action plans fell by 3.7%. ALMPs reach only a quarter of the unemployed. This does not match the government's stated ambition of improving the national employment policy and helping the most vulnerable unemployed people in finding proper jobs.

A further structural problem in Serbia is the constant outflow of human capital across the occupational spectrum. Like the rest of Western Balkan region, Serbia is facing a 'labour force drain' of multiple categories of workers, ranging from drivers and plumbers to teachers and medical staff. Annual emigration of workers is estimated as many as 50.000. Highly qualified people see limited career prospects and opportunities to fully apply and further develop their skills. A paradigm shift is needed from the policy and employer's perspective to create conditions to maintain human talent as dwindling human resources have a major impact on the growth potential of the economy. The diagnostic part of Serbia's ERP acknowledges this structural issue and is addressing it to some extent under *Reform Measure 21 (Providing prerequisites for monitoring, promoting and supporting circular migration in the ERP)***.** According to the introduced measure, Serbian nationals returning to the country can benefit from a tax deduction of up to 70% for several years. The measure is expected to have most impact on the ICT sector, which accounts for up to 5% of Serbian GDP. This is a step into the right direction as it provides incentives for highly qualified individuals in key areas of the economy. However, its implementation and potential impact remain to be seen. It would also be usefully complemented by an accelerated reduction of the overall tax wedge on labour to try and encourage people not to leave the country in the first place.

Informal employment decreased, but remains at a high level. The informal employment fell to 18.8% in 2019 but remains structurally high. Most informal work is concentrated in agriculture, where 64% of work on informal basis, but other sectors such as construction and domestic services are also affected. However, the measures brought in by the government to tackle the informal sector deal mostly with seasonal work in the agricultural sector.

Low work-intensity in marginal jobs is twice as high as the EU average. One worker out of five is employed in seasonal, part-time or casual jobs. The recent economic improvements have not yet led to substantial increases in income; the average monthly wage reached about €500 in late 2019, but the median salary is only €369. The minimum salary was increased by 11.1% to €257, which is still not a living wage.

Labour taxes and high non-wage labour costs at the lower end of the earning's scale impede the formalisation of labour. The recent amendments to the Law on Personal Income Tax adopted in December 2019 were too small to have any significant effect on lower wages. Measures such as the increase in the untaxable base from RSD 15,300 (€130.2) to RSD 16,300 (€138.7), the reduction in the pension and invalidity insurance contribution rate from 26% to 25.5%, and the reduction in the employers' payments from 12% to 11.5% are enacted with the objective to decrease the tax wedge. However, they have had hardly an impact on workers' net take home wage.

2019 saw the introduction of a law on temporary agency work. The flexibility this law provides for is expected to stimulate employment and labour market responsiveness.

The government has adopted a set of substantial stimulus measures for promoting employment of highly skilled individuals. From March 2020, tax incentives will be in place for both for Serbian citizens returning to the country and for foreigners. New employees registered as new residents with qualifications considered to be relevant or in high demand on the domestic labour market will benefit from tax reductions. The same approach will be applied to new companies with innovative businesses, in order to facilitate employment in the IT sector.

PISA results are below OECD average, but the best in the Western Balkans region. The 2018 PISA results demonstrate that Serbian secondary school students are clearly below the OECD average in reading (439 against an OECD average of 493), mathematics (448 against 489) and science (440 against 487). However, Serbian pupils remain the best in the peer group of the Western Balkans. Some 3% of students in Serbia were top performers in reading, achieving Level 5 or 6 in the PISA reading test (OECD average: 9%). Some 38% were low achievers in reading, 40% were low achievers in mathematics. Other countries in the peer group of the Western Balkans perform worse. The upper secondary education is not mandatory. This has a negative effect on skills of youth, which are the basis for youth employability. In fact, skills often fall short of labour market needs. It also affects the capability for lifelong learning later on.

Employers' perceptions and the research available point to a mismatch between the curriculum of existing secondary schools offering vocational education and training (VET) and the demands of the labour market. Although Serbia was one of only two WB countries to have created a system to anticipate skills needs, practical skills are still not taught adequately in VET high schools. In an attempt to address this issue, the ERP provides for r*eform measure 18 (Qualifications oriented towards labour market requirements).* Serbia is bringing in dual education modelled on the Austrian, Swiss and German system. The resultant closer link between theory and practice is expected to improve the quality of education, enabling a smoother transition from school to work. However, this will take some time to have an impact as participation in dual vocational education and training was only 5.3% of all VET participation in 2019. The target is to increase the participation rate to 8% in 2022. Studies prove that those, who have been through the dual system have significantly better chances of finding employment than those educated in other VET models. As a complementary measure, Serbia plans to create regional training centres within vocational secondary schools to support both dual education and conventional vocational education. The set of activities envisaged under this reform measure are clearly a step in the right direction and an appropriate measure to address the skills mismatch among young people.

Serbia has successfully joined the Bologna Process related to tertiary education system, which is now organised in three cycles that correspond to ISCED (International Standard Classification of Education) levels five to eight. However, the European Association for Quality Assurance in Higher Education (ENQA) concluded recently that, although progress has been made, the overall level of compliance with the European Standards in Higher education is not yet sufficient. Serbia has committed to EU policies in the field of education and training, for example by participation in the ET2020 Working Groups, in the implementation and monitoring of the EU priorities for VET 2015– 2020 (Riga Council Conclusions) and in its commitment and pledges to the European Alliance for Apprenticeships (EAfA).

MINT studies as science, technology, engineering, mathematics and ICT are rather under-represented in total enrolment, accounting for 30% of students. Overall, there is something of a mismatch between tertiary education and labour demand. Apart from subject choices, the root causes of skills mismatches between graduates and the skills in demand are outdated teaching methods and curricula, plus limited opportunities to gain practical skills through arrangements as internships.

Participation in lifelong learning has increased slightly from 4.4% to 5% in 2019. Given the existing skills mismatch on the labour market, there is a need for considerably investments in adult education. It is as well necessary to pass the respective laws and redraft adult curricula to encourage and incentivise adult learning. Further qualification is key for the integration of medium and low skilled people into the labour market. Reform *measure 19 (education system digitalisation and education management information system implementation)* is in line with the structural challenges identified. It is designed to encourage innovation in the education system by incorporating modern digital technologies, which should improve learning outcomes and boost young people‘s digital skills. It also provides for the introduction of the Education Management Information System (EMIS), which will be linked to with the Central Registry of Statutory Social Insurance, thus enabling the monitoring of graduates in the labour market. This reform measure, if successfully implemented, will help bringing the design of education policies into line with modern labour market needs.

Spending on state education under the national budget comes to around 3.5% of GDP, which is below the EU average of 4.6%. If Serbia is to move successfully towards a knowledge and skills based economy, it is vital to increase public spending on both education and research and development (R&D).

Key challenge #2: Strengthening the regulatory environment

The government made progress on tightening of the regulatory framework, but the transparency, predictability and proper implementation of legislation need to be further strengthened. In 2019, the government focused on improving compliance with EU legislation in the fields of public procurement, state aid and taxation; however, more efforts are needed to strengthen the implementation of policies in these areas. The business climate has improved, but remains hampered by red tape, political interference and the limited efficiency of public administration. Business predictability is negatively affected by the lack of full transparency in the adoption and the implementation of legislation. Government decisions in a number of businesses-relevant areas are still taken without proper consultation and under time constraints that do not always allow businesses to organise and adapt their operations to new rules in good time. In the private sector, there is a strong sense of unfair competition stemming from the outsized presence of public companies, non-transparent state aid schemes, a large informal economy and an insufficiently predictable regulatory environment. Further and deeper institutional reforms are needed to modernise tax administration, tackle bureaucracy, reduce corruption, and strengthen the judicial system.

Management of public investments is neither sufficiently transparent nor efficient. A significant share of public funds for capital investment is spent without proper checks to ensure compliance with public procurement, state aid and technical standards. In particular, a number of large-scale infrastructure projects have been designed under non-transparent inter-governmental agreements and special laws that exclude the application of the public procurement law. Investment decisions are often taken without conducting the feasibility studies, cost-benefit analysis and environmental impact assessments necessary to ensure the sound use of public funds. The Government adopted a decree on public investment management, paving the way for a single mechanism for the prioritisation of public investments. This should, in principle, result in a more sound project selection process, better prioritisation, stronger impact and more comprehensive planning across different tiers of the government. However, there are numerous exemptions from the application of the rules, which in practice makes the decree less effective. In addition to projects financed through public-private partnerships or concessions, which are not covered, the decree also leaves room for government discretion in selecting 'projects of special importance for the Republic of Serbia', in which case the rules do not have to be followed. The law on special procedures for implementation of projects related to construction and reconstruction of linear infrastructure, adopted in February 2020, further allows the government to exempt 'strategic' projects from public procurement rules.

The state continues to maintain a large presence in the economy, crowding out the private sector and negatively affecting economic dynamism. While most small-scale privatisations have been completed, several large companies remain publicly owned, particularly in the energy, transport (rail, road and air), insurance and telecommunications sectors. Many of these companies do not apply corporate governance rules and operate with low efficiency and high costs. Acting directors in many key public enterprises are appointed for indefinite periods of time, which violates the law on public enterprises. This stands in the way of a root-and-branch reform of these companies including more professional management. Serbia has, however, committed to adopt an ownership policy and an action plan focusing on improving the corporate governance regulatory framework of public enterprises. Although spending in support of public companies is decreasing, it remains high. Serbia has the third-largest share of employment in public companies among the 21 countries of central, eastern and south-eastern Europe, according to recent estimates by the International Monetary Fund (IMF). This outsized presence of state-owned enterprises (SOEs) deters private investment and innovation, impedes overall competitiveness and poses substantial fiscal risks. Improving the efficiency of public enterprises through restructuring or privatisation would reduce the strain on public finances and improve the quality of services. Moreover, it would create a more level playing field, limiting the preferential treatment accorded to some public companies.

Efforts are under way to tackle the informal sector, but reforms are being implemented at a slow pace. Driving forces behind the large informal economy, estimated at 25% of GDP, include high taxes and contributions on salaries, lack of financial resources and favourable loans, para-fiscal charges, hidden tax fees as well as red tape. While the government has been careful in reducing the tax burden in view of fiscal policy needs, it has clamped down on fight against the informal sector by stepping up tax and labour inspections. The labour inspectorate, for example, filed 31% more employment-related irregularities in 2018 than in 2017. Serbia adopted a National Program for Suppression of the Grey Economy for the period 2019-2020 and the Action Plan in April 2019, which envisages further improvement of the work of inspection bodies, a tougher penalty policy and more efficient tax collection.

Serbia is successful in attracting foreign investments, but companies established through FDI are mostly reliant on foreign suppliers. Serbia is among Europe's top ranked countries in terms of FDI jobs created per capita. However, policies designed to attract FDI are often not transparent and not in line with state aid and public procurement rules. More efforts are needed to link local SMEs to FDI companies through targeted SME upgrading programmes, to ensure foreign investors use more local inputs beside labour. The budget for SME policies is growing but remains modest compared to the subsidies and bespoke services offered to big investors. Those most in need of such support are domestic businesses, particularly small and innovative ones, which have a chance of reaching international markets.

Non-tax levies undermine the predictability and stability of Serbia's tax system. Companies regularly complain about the taxation system's unpredictability and the large discretionary levies, applied by local authorities or independent agencies to collect revenue (para-fiscal charges) for their services. After attempts to streamline the system of para-fiscal charges and make it more transparent in the past years, previously abolished charges (e.g. the environmental fee) are now being re-introduced. Progress was made in 2019 with modernising the tax administration and the reducing the number of field tax offices, which is expected to make the implementation of tax rules fairer and more predictable. However, further efforts are needed to make the tax system more transparent, improve consistency in implementing of tax rules, increase overall capacities of the tax administration, and step up the fight against illicit trade.

Additional efforts are required to tackle corruption and strengthen rule of law, contract enforcement and better regulation. An effective, independent judicial system is a prerequisite for a predictable investment and business-friendly environment, and is necessary to encourage innovation, attract FDI and secure tax revenues. However, the regulatory framework continues to pose problems in this area. Legislation is too often drafted and adopted through expedited procedures without any regulatory impact assessment. In many cases, no public consultations is held, or the results are not taken into account sufficiently. Frequent and opaque changes to legislation discourage compliance.

The business environment is burdened with numerous unnecessary costs and complicated administrative procedures. Serbia further improved its World Bank 'Doing Business' (2020) ranking by 4 places, reaching 44th place out of 190 economies in 2020. However, the administrative costs of doing business are estimated at between 3.26 and 4% of GDP. In July 2019, Serbia introduced an ambitious multi-year programme called 'e-Paper' designed to list, digitalise and optimise several administrative procedures and make them available to the public. The ERP develops this further through *reform measure 7* (*Simplification and elimination of business procedures - paper*). If implemented, the reform could significantly reduce administrative costs for businesses. However, results so far have been rather limited. Further steps are needed to streamline existing work and improve the quality of new regulations.

The ERP is strongly focused on improving the business environment, but difficult reforms face delays in design and implementation. This is particularly true for complex business support services, such as protecting investors, enforcing contracts, and fair competition and taxation. *Reform measure 8 (Transformation of tax administration*) one of the most significant structural reforms for years was part of previous ERPs. The implementation of the reform has continued, albeit slowly, notably as regards the implementation of the 2015-2020 general programme for transformation of the tax administration and the revised 2018-2023 action plan for its implementation. Core and non-core activities have been separated and the network of field offices has been reduced. Nevertheless, the desired changes, in terms of predictability and fairness in the implementation of tax rules are yet to fully materialise. Further efforts are also needed to improve the administrative capacity of the tax administration. *Reform measure 9* (*Improvement of geospatial sector through development of digital platform in support of decision-making for investments*), rolled over from previous ERPs, should help further clarify ownership, thereby helping to make the investment decision-making process easier. If implemented, this ambitious reform could significantly boost property tax revenues of local authorities that collect and use these taxes. However, a strong cooperation, communication and overall coordination remains to be established among a large number of stakeholders (local authorities), which are often inadequately staffed for this complex operation. Moreover, interoperability between multiple stakeholders' ICT systems has to be developed.

Key challenge #3: Greening Serbia's energy sector and fully opening the energy market

Serbia's energy sector remains unreformed and inefficient, impeding overall economic competitiveness and growth. The energy sector represents 4% of GDP. The vast majority of Serbian energy infrastructure is state-owned and operated by public enterprises that have through the years relied on state subsidies. The retail electricity market, though fully liberalised, remains highly concentrated given the dominant position of the incumbent supplier EPS. Entry barriers to the sector are high due to direct or indirect regulation of energy prices. It is therefore difficult for new technologies or players to enter the market. The country's energy supply continues to rely on lignite with drastic consequences in terms of pollution. In wintertime, air pollution regularly reaches record levels in several Serbian cities. Serbia continues to underperform in terms of energy efficiency.

Proper regulation of electricity and gas markets is key to improving the sector's efficiency and effectiveness. Serbia's primary legislation is compliant with the third energy package, but implementation is lagging behind, particularly in the gas sector. The long-awaited functional and legal unbundling of the electricity transmission system operator EMS has been completed. However, the functional unbundling of EPS, the energy company active in the field of electricity distribution, is still pending, as well as the long-delayed unbundling of Srbijagas, which continues to be involved in both supply and transmission.

Increased efforts are necessary to diversify supply and Serbia's overall energy mix. Serbia adopted a package of security of supply by-laws in the gas sector that go beyond its current obligations under the Energy Community Treaty. Nevertheless, ensuring security of supply for the domestic natural gas market remains a challenge. Serbia is dependent on imported natural gas for almost 80% of its total needs. Furthermore, the gas is imported via a single supply route and from a single supplier. There is no third party access to the existing gas network. Locally produced electricity comes primarily from lignite. Such a supply mix, characterised by high direct and indirect costs, is converted inefficiently and transported to sectors and industry with low purchasing power at a price that does not allow for full cost recovery.

Inefficient energy use represents a major concern in the country. Serbia has the second-highest energy intensity in the region, nearly four times higher than the EU average. Lack of efficiency in the energy sector critically impacts the country's overall economic competitiveness. In July 2019, Serbia brought in a new fee for energy efficiency. However, not all funds available are earmarked for financing energy efficiency measures. A more strategic approach is urgently needed to address all aspects of energy efficiency. It should tackle the need for improvements in financial, institutional and human resource capacities as well as better coordination with stakeholders at local government level and outside the government. Long-term and sustainable mechanisms to boost investment in energy efficiency should also be established.

Major investments are needed to make the energy sector more efficient and lower carbon emissions. Serbian energy infrastructure is generally old and outdated, resulting in high energy losses, particularly in distribution. Due to the reliance on coal-based energy supply, major investments are needed to combat air pollution and implement the necessary transition from fossil fuels to renewable sources of energy. According to a study by the Energy Community Secretariat (2013), Serbia needs to invest €640 million in the energy sector to comply with the Large Combustion Plant Directive and €710 million to comply with the Industrial Emission Directive. Investments in renewable energy have only very recently increased. In 2018, Serbia achieved a 20.32% share of renewables in gross final energy consumption, which is below the 25% median trajectory for 2017-2018 and even lower than the renewable energy share of 21% in the 2009 baseline year.

Serbia needs to increase its environmental investments substantially, also in view of obligations under EU *acquis*. Serbia should be aiming to cut emissions by 80-95% by 2050, in line with EU policy. Serbia's planned new investment in coal (such as construction of the 350 MW Kostolac B3 lignite power plant and the expansion of the associated mine from 9 to 12 million tonnes annually) risking locking it into a carbon-intensive energy system. A new fee for environmental protection was introduced in March 2019. However, the way in which this fee has been implemented is not consistent with its stated objective - observing the 'polluter pays' principle – so it does not provide a proper incentive for environmental investment.

Electricity tariffs are too low to enable the necessary investments to be made. Although the regulated prices of electricity for guaranteed supply were increased by 3.9% in December 2019, they still do not provide for cost recovery or the necessary investments. These prices should continue to increase gradually to close the gap between the market price and the regulated price of supply. This should be accompanied by appropriate social programmes to mitigate possible adverse effects, bearing in mind that a large proportion of the population falling within the status of absolute poverty and energy poverty.

Investments in the energy sector agreed through non-transparent inter-governmental agreements raise serious concerns. Such investments risk resulting in breaches of Serbia's obligations as regards the agreements signed with the EU. They also cause issues with standards and interoperability. Serbia should therefore exercise particular caution when it engages with investors from third countries.

Serbia's contribution in the energy sector is crucial to the success of the Western Balkans connectivity agenda. In 2019, Serbia made significant progress with preparations for the Serbia-Bulgaria gas interconnector. However, as regards the safe and efficient operation of the Continental Europe synchronous area, the non-implementation of the connection agreement between ENTSO-E and KOSTT, as foreseen under the EU-facilitated Dialogue between Belgrade and Pristina, remains a major bottleneck. Serbia should facilitate the entry into force of the connection agreement without further delay.

The ERP appropriately continues the measures to modernise Serbia's energy infrastructure, but fails to fully address the need to restructure publicly owned operators in the energy market. *Reform Measure 1* (*Energy market development coupled with energy infrastructure construction*) is designed to harmonise gas networks and construct missing interconnectors. The measure is rolled over from the three previous ERPs. If implemented, the reform would help improve Serbia's security of supply and modernise the gas network. Nevertheless, the reform would be more credible if it included practical measures to improve the functioning of the network and the market, such as the further restructuring of the inefficient producer EPS and a revision of electricity prices.

The ERP rightly provides for increased energy efficiency investments, but lacks detail on policy measures and the sustainable funding mechanism. *Reform measure 2* (*Improvement of conditions for enhancing energy efficiency through harmonisation of the legislative framework and establishing a sustainable mechanism for financing energy* *efficiency project*) identifies the need to secure sustainable funding for energy efficiency projects. However, concrete policy measures such as steps to implement consumption-based metering and billing in district heating are missing. In general, the measure lacks the ambition to effectively address Serbia's overall high energy intensity and incentivise energy efficiency investments. The government should include a clear plan to promote renewable energy and energy efficiency in the most vulnerable sectors, including heating and transport. More details on the funding mechanism are necessary to assess the sustainability of the reform.

Box: **Monitoring performance in light of the European Pillar of Social Rights**

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion for the benefit of citizens in the EU. Since the 20 principles are essential for countries if they are to achieve fair and well-functioning labour markets and welfare systems, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the aligning of their labour markets and welfare systems with those of the EU.

SERBIA		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU average, improving
	Gender employment gap	Worse than EU average, deteriorating
	Income quintile ratio (S80/S20)	Worse than EU average, improving
	At risk of poverty or social exclusion (in %)	Worse than EU average, improving
	Youth NEET (% of total population aged 15-24)	Worse than EU average, improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU average, improving
	Unemployment rate (% of population aged 15-64)	Worse than EU average, improving
	GDHI per capita growth	N/A
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU average, deteriorating
	Children aged less than 3 years in formal childcare	Worse than EU average, deteriorating
	Self-reported unmet need for medical care	Worse than EU average, deteriorating
	Individuals' level of digital skills	Worse than EU average, trend N/A

In most of the principles of the European Pillar of Social Rights, Serbia performs weaker relative to the EU average, according to the indicators of the Social Scoreboard[1]. Improving trends in employment have been observed over recent years. While in some areas lower performance is in a certain way unavoidable, since Serbia is poorer than any one of the EU Member States, more attention needs to be paid to fields that are less dependent on the level of national income, such as gender equality and inequality.

Women in Serbia have a significantly lower employment rate than men. The gender employment gap is wider than the EU-28 average (14.7 pps vs 11.6 pps in 2018) with a slight deterioration between 2016 and 2018. The wide employment gap is mainly due to the low activity of women in the labour market. The lower statutory retirement age for women and low level of part-time work (10.1% for women) combined with care responsibilities are some of the root factors.

Serbia's performance on social inclusion, social protection, income equality and poverty alleviation could be significantly improved. The at-risk-of-poverty rate stands around 24.3%, among the highest in Europe. Children and young people below 25 years of age face an at-risk of poverty rate of 29.1%. The at-risk-of-poverty-or-social-exclusion rate was very high in 2018 (34.3%) and significantly above the EU-28 average (21.9%). Disposable income of individuals in the top income quintile is on average almost nine times higher than of those in the lowest quintile. Serbia's tax-benefit system is not as efficient as elsewhere in Europe in reducing market inequality. Furthermore, high government expenditure does not reduce income inequality much. Pensions, for example, although they comprise more than 10% of GDP, among the highest shares in Europe, are less effective in reducing inequality than in the EU.

Serbia has a well-developed statistical system. The Statistical Office of the Republic of Serbia is the main producer of primary data from the Labour Force Survey and the Survey on Income and Living Conditions (SILC). The Institute of Public Health produces detailed statistics related to public health and demographic trends. The semi-governmental Social Inclusion and Poverty Reduction Unit is especially active in processing and interpreting data on poverty and inequality as well as developing indicators for monitoring of the social situation. In academic and civil society circles the monitoring of the social situation in Serbia is critically discussed, regarding methodology and results.

[1] The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The 12 indicators are also compared for the Western Balkans and Turkey, with one small adjustment for the age bracket for the unemployment rate (reducing the upper age bracket to 64 instead of 74 years) due to data availability. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around the EU-28 average, generally 2018 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). Data from 2016-2018 are used and can be found in Annex A.

5. Overview of the Implementation of the policy guidance adopted at the Economic and Financial Dialogue in 2019

Overall: Partial implementation (41.7%)[2]	
2019 policy guidance	**Summary assessment**
PG 1 Maintain the identified medium-term budgetary objective close to balance.	There was **partial implementation** of PG1. 1) **Full implementation:** The ERP estimates the 2019 deficit at 0.5% of GDP, thereby respecting the medium-term budgetary objective of 0.5% of GDP, which is close to balance. Moreover, outturn data point to an even lower 2019 deficit of 0.2% of GDP. The programme sets the medium-term budgetary objective at the same level as in the last two years, at a deficit of 0.5% of GDP
Contain overall spending on wages and pensions as a percentage of GDP.	2) **Limited implementation**: Only the share of pensions is stabilising, but wage increases have not been in line with the commitment. Although the ratio of spending on pensions to GDP is set to decline from 2020, following the introduction of the new pension indexation formula, the formula does not seem to be considered as a binding self-commitment; the authorities have already publicly announced possible revisions to the formula, in the first year of its application. The share of overall spending on wages and pensions as a percentage of GDP rose by 0.3 percentage points from 19.6% to 19.9% in 2019. This reflected nominal wage increases of nearly 10% of GDP, largely exceeding nominal GDP growth, while pension expenditure grew broadly in line with GDP. Moreover, the planned stabilisation in 2020 of the share of wages at the 2019 level of 9.5% of GDP also appears implausible or very difficult to achieve. This is because the additional average wage rises (by 9.5%) in the 2019 amending budget as of 1 December 2019 have had a substantial carry-over effect on 2020.
Implement the public sector wage system reform under the 2020 budget covering also security sector employees.	3) **No implementation**: The implementation of the public sector wage system reform has been postponed by a further year.

[2] For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en.

PG 2 Increase government capital spending supporting long-term growth as a share of GDP in 2019 and over the medium term. To this aim, develop a single mechanism for prioritising and monitoring all investment regardless of the source of financing. Strengthen the fiscal responsibility framework by improving the system of fiscal rules, increasing its credibility and making it more binding and capable of anchoring fiscal policy.	There was **limited implementation** of PG 2. 1) **Partial implementation:** There was some strong growth in capital spending from 3.9% to 4.9% of GDP in 2019 (above the ERP estimate of 4.4% of GDP). However, to a large extent this reflects a surge in security spending, while growth-supporting investment has increased more moderately. In view of the 2019 outturn, the planned trend in capital spending of 4.5%, 4.6% and 4.7% of GDP over 2020-22 would also represent a decrease as compared to the 2019 level.. 2) **Partial implementation**: While a new legislative framework for public investment management was indeed put in place in 2019, issues of transparency, assessment and prioritisation of investment remain. In particular, the new arrangement allows for too many exceptions to the rule, as also demonstrated by the new law on linear infrastructure projects of special importance. 3) **No implementation:** There has basically not been any progress on improving the system of fiscal rules in 2019. Any proposals, decisions and implementation have been postponed to 2020 and 2021.
PG3: Continue promoting the use of the local currency inter alia by fostering the development of interbank markets and secondary markets for government securities, and by considering additional ways to enhance long-term bank funding in dinar and hedging instruments. Implement the measures included in the recently adopted programme for resolving non-performing loans (NPLs) and the related action plan, including those aimed at further addressing NPLs in state-owned banks and government agencies. Finalise the privatisation and restructuring process of the remaining state-owned banks.	There was **substantial implementation** of PG3: 1) **Partial implementation**: Some progress was made to foster the development of interbank markets and secondary markets for government securities, including through the issuance of long-term benchmark dinar securities. Efforts have mostly focused on developing a market for government dinar securities, while no significant action was taken in terms of hedging instruments. 2) **Full implementation**: All measures included in the NBS action plan for 2019 were timely implemented, including in the case of the selling of the first tranche of the loans portfolio of the Deposit Insurance Agency. 3) **Partial implementation**: On 26 February NLB concluded a sales agreement with the Serbian government stipulating the acquisition of 83.23% of ordinary shares of Komercijalna Banka. The transaction will be closed in 2020Q4 and is subject to mandatory regulatory approvals from, among others, the European Central Bank, Bank of Slovenia and the National Bank of Serbia. Implementation of the reform agenda is progressing more slowly in the case of the remaining state-owned banks.
PG 4: Use findings of the smart specialisation exercise to finalise a new industrial strategy. Adopt specific legislation on the alternative investment vehicles.	There was **substantial implementation** of PG 4: 1) **Partial implementation:** Serbia finalised a smart specialisation strategy in February 2020 and adopted a new industrial policy strategy in March 2020. However, action plans to implement the two strategies have yet to be adopted. These action plans should ensure synergies between the strategies. 2) **Full implementation:** The Serbian parliament adopted two new laws on investment funds, in particular a law on open investment funds with a

Ensure that businesses and all social partners are consulted in time on all drafts of new legislation concerning their operations.	public offering and a law on alternative investment funds, in October 2019. 3) **Partial implementation:** The process of consultation has improved, especially as regards compliance with the legal obligation to hold public consultations on new policy proposals. However, government decisions in some business-relevant areas are still occasionally taken without appropriate consultation and under such time constraints that businesses have insufficient time to plan their operations under new rules. Businesses need to be better informed about regulatory changes and be actively invited to provide input in the process leading up to this regulation.
PG 5: Gradually adjust electricity tariffs to reflect actual costs, including the costs of necessary maintenance and investments to upgrade the energy network and of meeting environmental standards and climate goals Finalise unbundling of state-owned energy enterprises, in particular fully implement the long-delayed unbundling of *Srbijagas* and EMS and complete the functional unbundling of EPS in a compliant manner, as well as provide third-party access to gas infrastructure.	There was **limited implementation** of PG 5: 1) **Limited implementation:** The increase in price of electricity for access to the transmission system of 3.9%, for access to the distribution system of 2% and for the guaranteed supply of electricity of 3.9% were introduced in December 2019. However, the price of electricity on the regulated market (55% of total electricity consumption in Serbia) remains below the average for the region and far below the EU average. Further reforms are needed to ensure that the final price for electricity reflects actual costs taking account of investment needs, climate change commitments and social security implications. 2) **Partial implementation:** The functional and legal unbundling of EMS has been completed. The functional unbundling of EPS, on the other hand, is incomplete. However, some progress in these regards has been made. The legal separation of electricity distribution from EPS is complete and a statue of distribution company has been adopted. The unbundling of *Srbijagas* is progressing, albeit slowly. 3) **No implementation:** No steps have been taken towards providing third-party access to gas infrastructure.
PG 6: Significantly increase funding and the implementation of active labour market measures adjusted to the needs of the unemployed, in particular women, youth, including highly skilled persons. Adopt measures to incentivise the formalisation of labour in non-agricultural sectors. Reduce the high non-wage labour cost of jobs at the lower sections of the wage distribution.	There was **limited implementation** of PG 6. 1) **No implementation:** The Active Labour market Policies remain underfunded and the 2020 allocations have decreased. 2) **Limited implementation:** There is a strategy on tackling grey economy in place but it should be updated and accompanied by legislative measures in non-agricultural sectors. However, this has not happened yet. 3) **Limited implementation:** The reduction of the tax wedge was insignificant with a reduction of 1%. Notably low end wage earners should pay less taxes and social security contributions in order to alleviate poverty and to encourage formalisation of work.

6. ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2020-2022

Informal economy

The informal economy has been slowly shrinking over the years, but remains extensive, in terms of both its share of total output and in the number of people employed, and thus constitutes a major burden on business. Estimates of the size of the informal economy in Serbia range from 15.4% (NALED, 2017) to about 25% (IMF). Undeclared labour remains a persistent issue, despite some improvements in the labour market. Agriculture, construction and various types of household services have particularly high labour informality. The driving forces behind the large informal economy are corruption, high taxes and contributions on salaries, lack of financial resources and favourable loans, para-fiscal charges, hidden tax fees and red tape. While the government has been reluctant to reduce the tax wedge in view of the fiscal policy needs, it has stepped up the fight against the informal sector by increasing tax and labour inspections. The labour inspectorate, for example, filed 31% more irregularities in employment in 2018 than in 2017. Serbia adopted a National Program for Suppression of the Grey Economy for the period 2019-2020 and the Action Plan in April 2019, which envisages further improvement of the work of inspection bodies, a stricter penalty policy and a more efficient collection of tax revenues.

This year's ERP contains no reform measures addressing the issue of informality.

Research, development and innovation

Investment in research, development and innovation is weak. Industrial innovation, in particular, needs more support to increase the value-added of exports. Although the country has a relatively good scientific base, investment in research and development remains at 0.9% of GDP (half the EU average of 2% of GDP in 2017) and only one third of this amount comes from the private sector. The country lacks human resources for research and development. Only 2,081 (2018) workers per one million inhabitants are employed in this sector, significantly below the EU average of 4,060 recorded in 2018. Cooperation between businesses and academia remains weak and is not systematically supported. A new funding mechanism, the Science Fund, has been created, bringing a more competitive approach into the national system. Infrastructure for science and technology parks is being expanded, but support services for these institutions remain limited and need to be further expanded. Similarly, the Innovation Fund, which provides grants for industrial research, needs to play a more prominent role in the national funding system. In February 2020, Serbia adopted its first Smart Specialisation Strategy and a Strategy for the Development of Artificial Intelligence for the period 2020-2027.

Measure 12: Support for sustainable financing of research activities

This measure, introduced for the first time in the ERP, presents a general approach to a system for the organisation and financing of science through the newly created Science Fund and efforts to support excellence in research, strengthen R&D institutions and improve the link between research and industry. Some challenges, such as the lack of technology transfer facilities are not identified or addressed. The government budget for 2020 already provides for the necessary financial allocation for the operation of the Science Fund. Together with the new Science and Research Law and the Smart Specialisation Strategy, it sets out the main principles for further development of science, research and innovation. As in previous years, however, there is no indication of a plan to increase the percentage of GDP invested in science and research so as to catch up with the EU average.

Measure 13: Support for innovative start-up companies and digital transformation of companies

This measure supports the functioning of the Innovation Fund, which provides finance for industrial research. Both EU and national funds are used for this purpose. The government recognises the potential of the Innovation Fund and of innovations in general to boost the competitiveness of economy. The co-financing provided by the Ministry of Education, Science and Technological Development is steadily increasing. However, the reform seems to be progressing slowly as the only new activity proposed in the measure is the Acceleration Programme, although these programmes have been running for several years already. The Acceleration Programme, financed by EU IPA funds, is welcome, as it has the potential to bring support for the innovative start-ups to a higher level. However, the measure does not address the lack of venture capital and private sector expenditure in innovation.

Digital economy

Digital transformation remains a key priority for Serbia. Serbia's communications infrastructure requires systematic improvement in both regulation and investment. The broadband roll-out remains below the EU average. The lack of broadband prevents uptake of e-government and business services and as a consequence is slowing down the transformation of the economy. Investment of the ICT sector in research is above the national average, but still low compared to EU averages. In 2018, the ICT sector employed just 2% of total labour, but is estimated to have contributed significantly to the export of services (17%), has higher employment growth (10% per year) and pays higher salaries. The challenge remains to ensure there are links between the ICT sector and traditional industries so as to speed up modernisation in traditional sectors.

Measure 14: Increased availability of e-Government to public through enhancement of user-oriented services

The measure envisages further uptake of e-government services by developing supporting infrastructure facilities, notably a new secondary data management and storage facility for hosting e-government services in Kragujevac. The Kragujevac data centre, which has a disaster recovery function, should enable faster and uniform development of e-Government and reduce the costs of procurement, management and maintenance of ICT infrastructure procured by each body for its own needs. This measure is in line with the newly developed Programme for the development of e-Government of the Republic in Serbia, whose adoption is scheduled in the first quarter of 2020. Some of the planned activities, such as the enhancement of the existing e-government web portal are short term action. Others, such as the finalisation of a central information system in the area of hospitality and tourism and enhancement of the existing e-government web portal, should be completed by the end of 2020. Further uptake of e-government services is welcome as this can help improve the environment for business by speeding up procedures and reducing the scope for favouritism or corruption by the administration. However, the measure is limited in scope and refers to a single procedural reform rather than a systemic long-term reform with real impact on competitiveness. In addition to creating the technical infrastructure, more consideration should be given to the service that the government plans to roll out with the help of this new data centre. The planned activities are viable.

Measure 15: Improvement of e-government and education services through development of national information and communication infrastructure

This measure addresses the issue of Serbia's underdeveloped broadband network, particularly in rural areas, and focuses strongly on schools. The aim is to develop local wireless networks and link schools to the Academic Network of the Republic of Serbia. This is a welcome initiative. It is also an ambitious one, which will depend on good planning, securing adequate and timely financing and ensuring the coordination of the relevant institutions. The planned activities are cost effective.

Measure 17: 'Product info' – establishment of a single digital service for technical regulation

This measure implies linking together and improving databases of all quality infrastructure institutions and ministries responsible for adopting technical regulations on industrial products, standards, conformity assessment, accreditation, etc. The measure is introduced for the first time in the ERP. The importance of this newly proposed measure, designed to reduce technical barriers to trade, lies in its potential for making the economy more competitive and freeing up the free movement of goods flow between EU and Serbia. The measure builds up on the existing mechanism of the enquiry point for technical barriers to trade, by seeking to create closer links between various interlocutors as regards technical legislation on products and an information base for potential traders of goods. Ultimately, its impact will depend on the readiness of the institutions responsible for different products groups to input accurate data into the single digital contact point and platform. Although the initiative is good and fully in line with the recent EU requirements, its full implementation depends on inter-institutional consultations and cooperation. If fully implemented, it could improve efficiency in the harmonisation of national technical regulations in relevant areas. The planned activities are viable and cost-effective.

Investment activity

Despite the increase in public investments, particularly in roads and railways, it is still not at a level commensurate with the economy's needs. The institutional framework supporting new investment is weak. Even though a new legislative framework for public investment management was established in July 2019, issues with transparency, assessment and prioritisation of investment remain and need to be seriously addressed. Public procurement practices are not always fully compliant with the legislation, nor are they always fully compatible with EU standards, particularly where large infrastructure projects financed through government-to-government agreements are concerned. Serbia's economy continued to attract significant FDI during the period in question, well above the region's average. FDI has risen gradually in recent years. FDI inflows rose to EUR 3.8 billion in 2019, the highest recorded in recent years. Investment is spread across many sectors, with more than a quarter going into manufacturing. The top 15 exporters are mainly foreign-owned, jointly securing about a quarter of total exports. Backward linkages between FDI and domestic firms remain weak. Tailor-made measures are needed to link incoming investors with domestic suppliers, integrating them further in their value chains. Existing programmes for internationalisation of SMEs need to be stepped up to reach a higher number of beneficiaries.

Measure 10: Establishment of a sustainable system for funding environmental protection

This reform measure provides for a much-needed sustainable financial, legislative and institutional framework for investment in environmental protection. It was already introduced in the 2019-2021 ERP. As activities did not advance, this year's ERP repeats the proposal, in practice postponing its implementation for another year. The measure is welcome, as environmental protection is one of the most budget-intensive and complex chapters in the process of Serbia's EU accession negotiations. Current investment levels are far too low to enable Serbia advancing towards accession in this chapter in good time. Serbia's negotiating position estimates investment needs of €7.5 billion in the water and waste sectors alone. The description of the measure lacks the most basic information, which makes it impossible to assess its effectiveness in a meaningful way. Serbia should take more urgent action and be more ambitious in terms of timelines and funding levels. It should immediately move towards the implementation of the polluter pays principle and earmark all income from environmental fees for environmental purposes to increase budgetary resources available.

Trade performance

Trade performance continued to improve in 2019, but external imbalances increased. Trade openness rose to above 112% of GDP from 92% in 2014 as both imports and exports maintained strong growth. 93.3% of Serbian products benefit from duty-free access to the EU market. Exports rose by 7.7% in 2019, driven largely by strong domestic demand and constantly strong dinar. However, external imbalances increased as higher investment and consumption pushed up imports by 8.9%. Nevertheless, the current account deficit remained fully covered by net FDI inflows. Metals, cars, car parts and electric appliances were the most significant export sectors. Although a drop in export growth was noted for motor vehicles and steel, compared to 2018, the EU tariffs on steel introduced in June 2018 had no significant impact on Serbia's ability to export the steel products concerned to the EU. The same sectors were the most significant sectors on the import side as well, along with energy imports, which is the top import category, amounting to 6.6% of total imports of goods. Iron and steel accounted for nearly 30% of import growth, the largest share.

Serbia continued its participation in the Central Europe Free Trade Agreement (CEFTA), but further efforts are needed to fully implement all aspects of the Multi-annual Action Plan for the Regional Economic Area. Serbia is the region's only net exporter and CEFTA remains the country's second-largest trade partner after the EU. Regional cooperation has delivered concrete results, including the regional roaming agreement, an agreement on trade facilitation, a regional investment reform agenda, a decision on authorised economic operators, a decision to liberalise trade in services and an agreement to facilitate trade in fruit and vegetables. Further efforts are needed to continue with the ongoing implementation of the CEFTA Additional Protocol (AP) 5 on Trade Facilitation; the implementation of AP 6 on Trade in Services, following its ratification in February 2020; and playing constructive role for ensuring the finalisation of negotiations of the CEFTA AP 7 on Dispute Settlement in 2020. These priorities are correctly identified in the ERP, notably in reform measure 16 (*Improving conditions for and removing obstacles to trade*). It is important that regional initiatives include all Western Balkan partners and are in line with EU rules, building on existing commitments...

Measure 16: Improving conditions for product safety and removing barriers to trade

This measure has been rolled over from previous ERPs. Advancing trade integration with the EU and CEFTA means easing conditions at the border and beyond. The measure focuses on the implementation of the Regional Economic Area Multiannual Action Plan. Significant practical steps are needed to expedite the shipping of goods across the region and reduce the cost of shipping. Similar steps at the EU border would be most welcome. Reducing barriers to trade is important to strengthen the competitiveness of the economy and boost economic growth, in both the short and the long term. Businesses continue to face systematic inspections at the border because of the non-recognition of EU certificates. Cumbersome inspections hampering trade could be classed as measures having an effect equivalent to quantitative restrictions. The activities planned under CEFTA are appropriate and credible. Serbia should continue to play a constructive role within CEFTA. In addition, Serbia is committing to making certain amendments to its law on genetically modified organisms that constitute a major stumbling block in the WTO accession process. Serbia's announcements need to be followed up rapidly and resolutely, which has not always been the case unlike in the past.

Transport

Transport infrastructure is suffering from years of poor maintenance and underinvestment, hampering faster trade expansion. An updated transport strategy leading to an EU *acquis* compliant transport sector, has not yet been put in place in Serbia. Critical improvements are needed in traffic management, maintenance, and road safety. More adequate funds for these goals are now being secured, but timely implementation remains a challenge. The reform of the railway system is ongoing but progress needs to be maintained. River ports have started to become an important trade channel, but they need to be further upgraded and their full interoperability with roads and railways needs to be secured.

Measure 3: Improvement of the capacity and quality of road transport through reform of road sector to allow government to contract with state road operator and continued implementation of new performance-based maintenance contracting

This measure has been rolled over from previous ERPs. It proposes expanding the new performance-based arrangements for maintaining the state road network in order to make operations more efficient and effective. The measure deals with an important element of the ongoing reform process, which had been highlighted under the Connectivity Agenda as a priority reform measure. However, it fails to address several areas relevant for an overall increase of capacity and quality of the road transport. This includes improvement of road safety at national and local level, easing of the border crossing procedures and bringing in an intelligent transport system (ITS).

Measure 4: Reform of railways through enhancement of rail transport safety and improvement of regulatory framework

The reform of the railway sector, announced in previous ERPs, is progressing and this measure presents further steps to advance and complete the process. It deals with both the rail transport safety and with the opening up of the rail market. The new methodology for track access charges is an important element for the further liberalisation of the rail market in Serbia. However, the measure has a narrow focus. It does not tackle other important aspects of rail reform such as the facilitation of border crossing procedures, the granting of train driving licenses and safety certificates to foreign operators and mutual recognition of the rolling stock. Nor does it deals with railway infrastructure maintenance, although this is an important aspect for cost-effective operation of railway traffic. Using rail to export and import goods should be more systematically encouraged to reduce pressure on the environment and on roads.

Agriculture

The importance of agriculture for the economy is slowly diminishing, but remains significant when coupled with the more dynamic food processing sector. Agriculture accounts for slightly more than 7% of gross added value, but employs around one-fifth of the labour force. Together agriculture and exports of food products contribute significantly to employment and the balance of payments (15% of all exports). Exports to the EU even dropped. Weather conditions continue to have a strong influence on the sector performance. Other difficulties facing the agricultural sector are (i) land fragmentation, (ii) low productivity due to outdated technologies, (iii) small economic size and (iv) low utilisation of agricultural land per farm. Moreover, the sector faces the challenge of meeting EU obligations in the areas of food safety, veterinary and phytosanitary regulation, strengthening of responsible authorities in those areas, and a need to improve border inspections as regards risk analysis and risk-based performance. Moreover, the real estate market for agricultural land is hindered by the weak cadastre/property registration, as well as the lengthy procedures for case settlements in courts.

Measure 5: Improvements to competitiveness of agriculture through enhancement of rural infrastructure, land management, and regulation of markets and quality of agricultural products

This measure is rolled over from previous ERPs. It includes four distinctive actions: enhancement of rural infrastructure; land consolidation; regulation of the market in agricultural products; and regulation of agricultural product quality. The first two actions are particularly appropriate as they address the lack of infrastructure and fragmented land, which are main obstacles of development of agricultural holdings in rural areas. However, they are both ambitious and costly. The measure therefore needs clearer targeting of finances, which seems to be missing from the approved 2020 budget and the medium-term financial perspective. Legislation regulating areas under the other two actions (regulation of the markets of agricultural products and regulation of agricultural product quality) has been delayed. The law has yet to be implemented. In fact, the necessary implementing rules have not yet been adopted. It is strongly recommended that action to restructure the system of agricultural subsidies be included under this measure. In its current form (fragmented subsidies provided on every level of state administration) the measure will not really help improve the competitiveness but has rather a social character.

Measure 6: Improvement to management of register of agricultural estates and approval of national agricultural subsidies through development of e-Agrar web

This new measure involves optimising and digitalising the procedures for submitting and processing applications for entry in the register of agricultural holdings and national approvals of incentives in agriculture. The reform is closely linked with a pre-condition for EU accession – the existence of a functional Integrated Administrative and Control System (IACS). E-Agrar will be essentially an extended IACS to the national subsidies, so most of the modules planned to be built under this measure will later be the functional parts of the IACS system needed for transparent distribution of the common agricultural policy payments after the accession. Given the number of applications in national schemes per year (ca. 150 000), the planned costs of providing the training for the farming community seem to have been underestimated. It is important to plan financial resources for the IT equipment required for extension services and other regional entry points of the system.

Industry

The competitiveness of industry is key to growing the economy. Support for incoming FDI is principally geared towards attracting manufacturers. After years of declining industry, its share in GDP has now stabilised. Industry accounts for a quarter of value added. While manufacturing is stable, the performance of traditional industries such as mining and electricity generation varies considerably. The new industrial policy strategy, adopted in early March, is based on the results of the smart specialisation strategy, adopted in February 2020. Its measures should be more targeted on the sectors and firms with most potential. While support for investment is well rolled-out, other services are less developed. Clusters, technology parks, internationalisation, and industrial research do exist, and new standards or digitalisation in traditional industries have been introduced; however, these have not yet had a systemic impact. Measures of these kinds should be stepped up and their full compliance with state aid rules should be ensured.

Measure 11: Introduction of circular economy concepts through definition of strategic framework

This is the first time the ERP introduces a measure to promote the circular economy. The measure envisages the development of a guiding policy document and an action plan for the circular economy by the end of 2020. This should lead to the inclusion of circular economy concepts in policy documents in relevant fields**.** The reform is very welcome as it recognises the benefits of circular economy for the environment, innovation, economic growth and job creation. This is particularly important in view of Serbia's need to improve in resource savings, energy efficiency and environmental protection. However, though it is a first step in the right direction, the measure lacks ambition. It does not include any immediate practical steps towards a circular economy, which would need to be underpinned by appropriate budgetary allocations and robust performance indicators. In fact, there is no indication of the budget required for reform.

Services

Services account for over half of the economy and nearly30% of total exports. About half the value added by services comes from retail, real estate and healthcare. Services have been increasing their share in total exports and have a potential to expand further. Service exports are dominated by tourism, transport and ICT services. To further expand these fast growing and competitive services, investment in infrastructure and skills needs to be tailored to their needs. Targeted efforts are also needed to slow down the ongoing brain drain of most skilled labour. The Stabilisation and Association Agreement with the EU, does not provide for a framework for the liberalisation of services, but this does not significantly affect the above sectors. The CEFTA agreement highlights further sectors in which services could expand regionally, if enough progress were made towards achieving mutual recognitions of qualifications and certificates is accomplished. Belgrade is well-positioned to function as a hub for the regional provision of many skill-intensive services.

Education and skills

This sector and the relevant reform measures 18 and 19 are analysed above in section 4 under key challenge #1.

Employment and the labour market

This sector and the relevant reform measures 20 and 21 are analysed above in section 4 under key challenge #1.

Social dialogue

Social dialogue needs further development, in particular in the private sector. Collective agreements are mostly concluded in the public sector. Only few agreements at branch level exist in the private sector. The tri-partite Economic and Social Council of Serbia needs to step up its visibility and impact. The social partners are not involved enough in social policy development.

Social protection and inclusion

The recent economic improvements have not yet led to substantial income increases; the average monthly wage reached around EUR 420 in 2018. However, three out of four workers' earnings are lower. Serbia's performance on social inclusion, social protection, income equality and poverty alleviation could be significantly improved. The at-risk-of-poverty rate stands around 24.3%, among the highest in Europe. Children and young people below 25 years of age face an at-risk of poverty rate of 29.1%. Disposable income of individuals in the top income quintile is on average almost nine times higher than of those in the lowest quintile. There are significant territorial disparities in income. Minority groups belong to the vulnerable employment groups and also to the low end of the income scale.

Measure 22: Improvement of the adequacy, quality and targeting of social protection measures.

The reform measure foresees the introduction of a so-called Social Card monitoring system. This is a national database, where all social beneficiaries are registered. The objective is not to increase the benefits but to prevent abuse of benefits. The introduction of a monitoring system is a good step towards e-government. However, it will not alleviate the poverty risk in the country. Serbia needs to complement it by measures, which address the high risk-of-poverty-rate in the country.

ANNEX A: OVERVIEW OF THE MAIN INDICATORS PER AREA/SECTOR OF THE ECONOMY

Area/Sector	2018	2017	2016	EU-28 Average
Energy				
Energy imports dependency (%)	N/A	33.8%	29.7%	55.1% (2017)
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	428.60	453.69	453.87	117.69
Share of renewable energy sources (RES) in final energy consumption (%)	20.32%	20.29%	N/A	17.98%
Transport				
Railway Network Density (meters of line per km^2 of land area)	N/A	N/A	N/A	49.9 (2016)
Motorization rate (Passenger cars per 1000 inhabitants)	N/A	280	N/A	507 (2017)
Agriculture				
Share of gross value added (Agriculture, Forestry and Fishing)	7.7%	7.3%	8.2%	1.6%
Share of employment (Agriculture, Forestry and Fishing)	15.9%	17.2%	N/A	4.0%
Utilised agricultural area (% of total land area)	N/A	38.8%	N/A	40.0% (2017)
Industry				
Share of gross value added	25.4%	26.5%	26.3%	19.1%
Contribution to employment (% of total employment)	22.5%	21.2%	20.2%	17.3%
Services				
Share of gross value added	61.5%	61.2%	60.8%	73.8%
Contribution to employment (% of total employment)	57.2%	57.5%	57.0%	71.9%
Business Environment				
Rank in World Bank Doing Business (Source: World Bank)	43	47	54	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	65	78	94	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	N/A	N/A	Up to 34.5%	
Research, Development and Innovation				
R&D intensity of GDP (R&D expenditure as % of GDP)	0.92%	0.87%	0.84%	2,12%
R&D expenditure – EUR per inhabitant	56.3€	48.60€	43.60€	656.5€
Digital Economy (TBC)				
Percentage of broadband penetration (Mobile and fixed) [NB: households]	73%	65%	N/A	86%

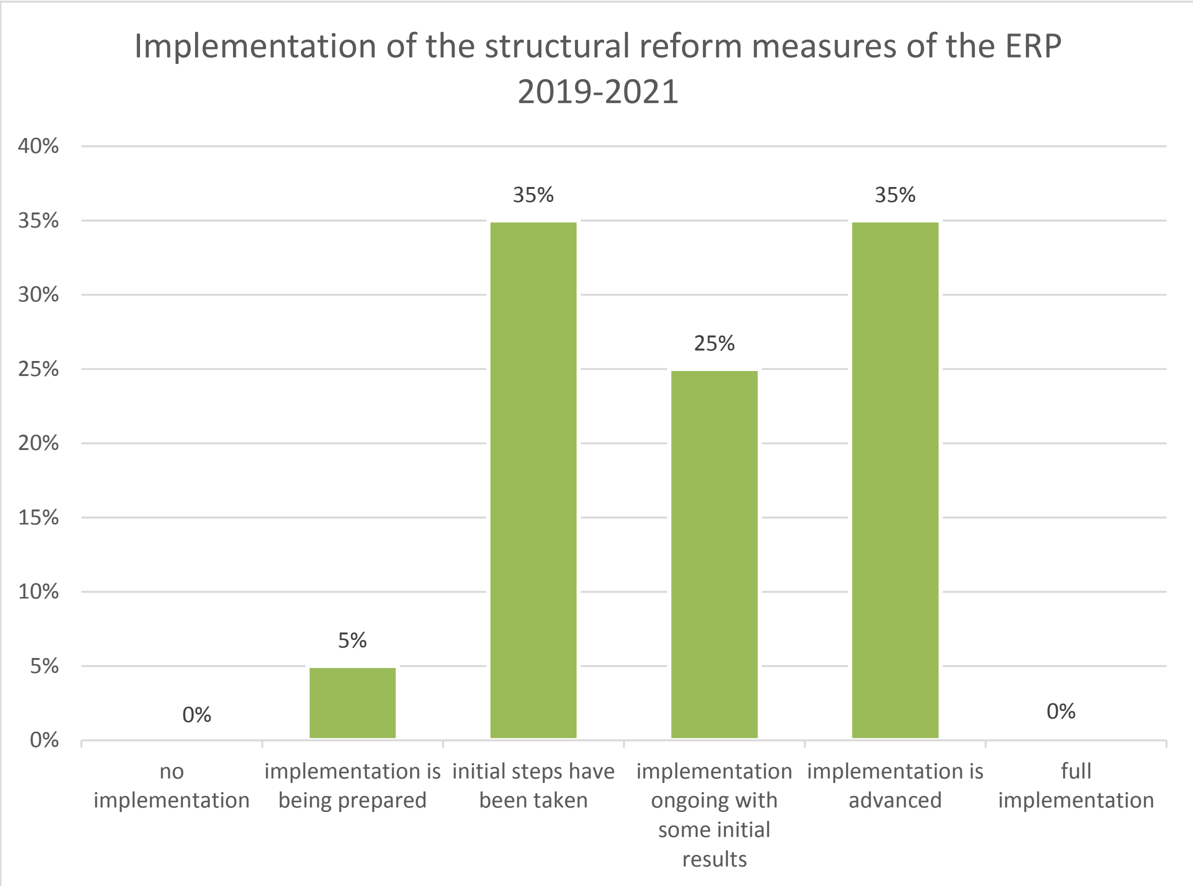
Share of total population using internet [NB: population 16-74]	73%	70%	N/A	85%
Trade				
Export of goods and services (as % of GDP)	50.8%	50.5%	48.6%	46.2%
Import of goods and services (as % of GDP)	59.3%	57.1%	53.4%	43.0%
Trade balance (as % of GDP)	-13.2%	-11.1%	-9.9%	
Education and Skills				
Early leavers from education and training (% of population aged 18-24)	6.8%	6.2%	7.0%	10.5%
Youth NEET (% of population aged 15-24)	16.5%	17.2%	17.7%	10.5%
Formal child care - children aged less than 3 years (% of total)	13.3%	14.5%	18.1%	35.1%
Individuals' level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	N/A	39%	N/A	57% (2017)
Employment				
Employment Rate (% of population aged 20-64)	63.1%	61.4%	59.1%	73.2%
Unemployment rate (% of labour force aged 15-64)	13.3%	14.1%	15.9%	7.0%
Gender employment gap (Difference between the employment rates of men and women aged 20-64)	14.7%	14.0%	14.4%	11.6%
Social Protection System				
% of population at risk of poverty or social exclusion	34.3%	36.7%	38.5%	21.9%
Impact of social transfers (Other than pensions) on poverty reduction	17.91%	18.67%	21.28%	33.2%
Self-reported unmet need for medical care (of people over 16)	5.8%	4.8%	4.5%	2.0%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	8.58	9.38	11.02	5.17

Source: EUROSTAT, unless otherwise indicated.

ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2019-2021

There was some progress in implementing the measures in 2019, with an average score of 3.3 out of 5. The reporting on the planned activities is precise and fair. Some relatively easy reform steps contribute to higher grades, but overall there is a good description of the level of implementation and indication on what remains to be done.

The highest level of implementation involves the measures on business environment, in particular the improvement of the access to finance for SMEs and enhancement of the effectiveness of inspection oversight. However, for a number of other measures, particularly complex ones, the implementation rate drops significantly, often to below 50%. As in the previous years, the pace of implementation in the area of governance of public enterprise is very slow. No relevant measure was included in this year's ERP. The slow implementation has also been noted in the areas of environmental protection, financing and competitiveness of agricultural producers and processors.



ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government adopted and formally submitted the Economic Reform Programme on 31 January 2020. The programme is in line with the medium-term fiscal strategy and the 2020 budget and covers 2020-2022.

Inter-ministerial coordination

Preparation of the Economic Reform Programme (ERP) 2020-2022 was coordinated by the Ministry of Finance (Minister of Finance was appointed as a national coordinator) and the Secretariat for Public Policies. National Bank of Serbia (for macro-fiscal part) and a number of line ministries (for structural reform measures part), together with some other relevant institutions, were also contributing through a working group established specifically for this exercise. Several trainings, in particular by the Centre of Excellence in Finance (CEF) and GIZ, were organised for those involved in preparation of the document.

Stakeholder consultation

The national authorities involved stakeholders in the process of the preparation of the document. Several rounds of consultations with a wide range of stakeholders were organised, as well as a meeting with the National Convention, which gathers about 700 social partners, NGOs, business associations and other relevant stakeholders in Serbia. The participants were given sufficient time to comment in writing and the draft was made available on-line. Comments received from stakeholders were included in the annex of the Economic Reform Programme document.

Macro framework

The programme presents a clear and concise picture of past developments. It also covers all relevant data at the time of drafting. The macroeconomic framework is sufficiently comprehensive and coherent. The baseline macroeconomic scenario is broadly plausible and major uncertainties and risks are clearly outlined and recognised. The programme presents an alternative macro-fiscal scenario resulting in lower economic growth and higher budget deficit and debt levels. While the underlying assumptions are set out in a good level of detail and quantified, the alternative scenario may seem relatively benign in view of the magnitude of the underlying risks and of historical experience.

Fiscal framework

The fiscal framework, based on the baseline medium-term macroeconomic scenario, is sufficiently comprehensive and integrated with the overall policy objectives. In general, most revenue and expenditure measures are sufficiently explained, although the medium-term impact of some of them is not covered in sufficient detail. The programme does not contain any long-term projections of population trends or of the implications of an ageing population for the labour market and public finances, notably as regards health and pension systems. Significant further efforts would be needed to ensure the fiscal data are compatible with ESA 2010.

Structural reforms

Reporting on implementation of the 2019-2021 structural reform measures is detailed and up-to date. The ERP presents 22 reforms, 2 more than the maximum suggested by the guidance. The quality of measures vary. In some cases, measures are narrow in scope, well targeted and planned in good detail, while in others they are overly ambitious and wide in scope. The annexed tables are filled in appropriately.

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