Republic of Serbia
Country Economic Memorandum

The Road to Prosperity: Productivity and Exports

Volume 1 of 2: Overview

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Poverty Reduction and Economic Management Unit
Europe and Central Asia Region
CURRENCY AND EQUIVALENT UNITS

Currency Unit = RSD (Serbian dinar)
US$1 = RSD 74.35
(As of November 8, 2011)

FISCAL YEAR
July 1 – June 30

ACRONYMS AND ABBREVIATIONS

ALMP  Active Labor Market Policies  LFS  Labor Force Survey
ATPs  Autonomous Trade Preferences  LPI  Logistics Performance Index
BEEPS  Business Environment and Enterprise Performance Survey  MATW  Ministry of Agriculture, Trade, Water and Forestry
CAP  Common Agriculture Policy  NBS  National Bank of Serbia
CEEC  Central and Eastern Europe Countries  NES  National Employment Service
CEFTA  Central European Free Trade Agreement  NMI  National Metrology Institute
DCR  Directorate for Commodity Reserves  NQI  National Qualify Infrastructure
DMPM  Directorate of Measures and Precious Metals  OEM  Original equipment manufacturer
EBRD  European Bank for Reconstruction and Development  PISA  Program for International Student Assessment
EC  European Commission  PPP  Public-private Partnership
ECA  Europe and Central Asia  PS  Product space
ECE  Early childhood education  REC  Real Estate Cadastre
EDB  Ease of doing business  SAA  Stabilization and Association Agreement
EI  Energy intensity  SEE  South Eastern Europe
EPS  Electric Power Industry of Serbia  SME  Small and Medium-sized Enterprises
ETI  Enabling Trade Index  SOE  Socially-owned enterprise
EU  European Union  TFP  Total Factor Productivity
FDI  Foreign direct investment  TTFSE  Trade and Transport Facilitation in South Eastern Europe
FTA  Free Trade Agreement  TVET  Technical and Vocational Education and Training
GDP  Gross domestic product  UB  Unemployment benefits
ICA  Investment Climate Assessment  USS  US dollar
IPARD  Instrument for Pre-Accession Assistance for Rural Development  VAT  Value Added Tax
ISS  The Institute for Standardization of Serbia  WTO  World Trade Organization

Vice President:  Philippe H. Le Houérou, ECAVP
Country Director:  Jane Armitage, ECCU4
Sector Director:  Yvonne Tsikata, ECSPE
Sector Manager:  Satu Kähkönen, ECSPE
Task Team Leaders:  Lazar Šestović, ECSPE
Peter Miović, STC
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EXECUTIVE SUMMARY

Before the crisis Serbia’s growth performance had been solid, but characterized by major imbalances. In the last decade, Serbia’s growth relied primarily on domestic demand. In the future, however, Serbia could do much better by emphasizing the development of exports as a new, potentially powerful, source of growth. The share of exports in Serbia’s GDP, currently only 25 percent, should be double or triple of that, which is the current average for the new EU member states. The point is not that consumption should be cut but that by pushing exports and thus speeding up growth, all components of GDP could grow faster.

EU accession is a major opportunity not to be missed. On October 12, 2011, the European Commission recommended granting Serbia candidate status for membership in the European Union (EU). This landmark event on Serbia’s road to the EU reflects the significant progress Serbia has made so far in structural and institutional reforms. These reforms are preparing the country for the opportunities and challenges of joining the ranks of one of the world’s largest economic blocks. Within this context, this report explores the opportunities and challenges that Serbia faces in accelerating economic growth in a complex international environment.

Serbia also needs to explore options of accessing important markets beyond Europe. Traditionally, Serbia traded with numerous developing countries, and needs to explore options for returning also to those markets. This is particularly important given the depth and length of the current international economic crisis and the state of the economies of some of the major Serbian trading partners in Western Europe. But tapping these opportunities is by no means automatic. Important internal challenges must be overcome and ways to compete with countries from the emerging world, primarily from Asia, needs to be found. The key to success for Serbia will be implementing and sustaining a series of macroeconomic, sectoral, and microeconomic reforms to make its economy much more competitive, productive, and export-oriented.

This report looks beyond the current global financial crisis to the restoration of dynamic long-run growth in Serbia. The global financial crisis has already had significant impact on Serbia that may be felt with even greater force in coming months and years. The inflow of investments and loans has almost vanished, the economy has slipped into recession, unemployment has increased and living standards have deteriorated. With monetary policy still focused on controlling inflation, fiscal policy is the primary buffer against spillovers from the crisis. The government has carried out a painful budget reshuffling and is using the support of the international financial institutions to moderate the impact of the crisis. Once the crisis passes, the big question is how Serbia can find a rapid, sustainable growth path and best take advantage of the economic opportunities of the EU membership and access to numerous foreign markets.

The answer in this report is that Serbia will need to fundamentally alter its growth model to compete effectively in world markets. The past model relying on excessive inflows of capital and credit that, in part, fuelled a consumption boom has
run its course in all European countries. Serbia must shift to a greater export orientation so that it can attain the major gains in productivity and competitiveness necessary to propel economic growth to a much higher trajectory. This cannot happen without an explicit export strategy, and a set of concomitant structural reforms, driven by commitment and coordination at the highest political level.

**International experience shows that igniting rapid, export led growth is possible.** Countries less favorably located and with fewer resources have achieved it. There is no reason why a European country in the vicinity of the largest European markets and on the road to EU membership should not also accomplish it. The EU history is an important guide: All new member states started from a similar position of major structural challenges, yet today their incomes are far closer to the EU average than before membership. One of the world’s largest markets awaits Serbia’s companies and entrepreneurs. Challenges to government, sectors, and firms are surmountable, but will require concerted and sustained effort, monitoring of progress, and vigilance to confront new problems as they emerge. In general, this challenge cannot be met by the public sector alone. While it has much to do – improve the investment climate, reduce regulatory barriers, upgrade infrastructure – domestic and foreign private partners will be central to the success of Serbia’s new export strategy.

**Over the medium term, Serbia needs to concentrate more effectively on making the most of the EU accession, as well as to expand its trade with other huge foreign markets.** Export-led growth is necessary to convert Serbia’s significant resources into higher Serbian living standards. Some sectors are already better positioned than others to export. Sectors in the traditional export base of Serbia, such as food products, still have vast potential for growth. Others, such as the metals industry, emerged more recently after a successful restructuring of the old socially owned enterprises. Still others, such as the automotive sector, are reemerging and already offer a promise of major industrial transformation and of export growth not seen in Serbia for decades. Indeed, there are major opportunities in Serbia and throughout European markets for these sectors and the related value chains, not to mention many other activities and products. The rising sophistication of Serbia’s exports and many “emerging export champion” goods attest to the ability of the economy to produce and export even under current constraints.

**The number one task of the authorities now is to accelerate reforms to create an environment that is highly conducive to export-led growth in the private sector, both domestic and foreign owned.** This report identifies four constraints to private sector growth: skills of available labor and opportunities for their upgrade, supply of electric power, access to land and property rights, and trade facilitation (e.g. performance of the transport and logistics sectors). In all these areas, there are many remaining constraints that hamper prospects for private businesses and discourage more significant inflows of much-needed foreign direct investment (FDI).

**Responsible fiscal policy will continue to be necessary, even though some reforms might turn out to be costly.** Many of the measures proposed in this report will require additional public expenditures on, for example, active labor market policies, expansion of adult training, additional incentives to attract FDI, expansion of agricultural extension services, and building agricultural supply chains. There are also costs related to removing the key obstacles to doing business, streamlining trade
facilitation, and dealing with land and energy issues. The fiscal envelope needs to make room for these measures without violating the spending rules and the deficit ceiling set out in the fiscal responsibility legislation. At the same time, Serbia still has options for introducing different legal changes that at the same time mean significant improvements in the business environment and have no or only limited fiscal costs.

A brief Policy Matrix at the end of this section summarizes the priority short and medium term policy recommendations, while the full overview of the key policy recommendations is provided at the end of the document (in Annex 1). This longer version of the table with policy recommendations is supplemented with a rough estimate (low, medium, high – marked as €, €€ or €€€) of the possible costs of implementing the suggested reforms. The purpose of this rough estimate of costs associated with different reforms is to provide an option to policy makers to prepare a package of relatively inexpensive but still important reforms that could be frontloaded.
## Priority short and medium-term policy measures

### In the Short Term

<table>
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<tr>
<th>Industry</th>
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<td>Target high-value-added FDI through investment promotion programs.</td>
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<th>Agriculture</th>
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<td>Make the public policy process more predictable by adopting and sticking to a sectoral strategy.</td>
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<td>Build an effective extension service.</td>
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<th>Business Environment</th>
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<td>Continue to develop national quality infrastructure to reach EU standards</td>
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<th>Skills</th>
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<td>Expand Active Labor Market Programs (ALMPs) that have been successful,</td>
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<td>Reform curricula in both general and technical/vocational streams of secondary education</td>
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<td>Introduce measures to reduce the average length of studying in higher education</td>
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<td>Make the power sector financially viable by increasing tariffs and cutting unjustifiable costs and losses.</td>
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<td>Assign and train a dedicated team to deal with conversion of land use into ownership rights.</td>
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<td>Simplify procedures for issuing construction permits.</td>
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<th>Trade Facilitation</th>
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<td>Rethink Integrated Border Management and consider juxtaposing border facilities</td>
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### In the Medium Term

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<th>Industry</th>
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<td>Promote private sector partnerships and investments in R&amp;D.</td>
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<th>Agriculture</th>
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<td>First reallocate budget resources away from ineffective support measures (like area payments, milk subsidy), then gradually increase the budget envelope until key reforms are adequately resourced.</td>
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<th>Business Environment</th>
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<td>Prepare the inventory of business related national and subnational procedures.</td>
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<th>Skills</th>
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<td>Explore additional ALMPs and scale up those with positive impact evaluations</td>
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<tr>
<td>Intensify efforts to reduce early school leaving in secondary education</td>
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<tr>
<td>Build field-specific knowledge with transferable skills in higher education</td>
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<th>Energy</th>
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<td>Implement the new Energy Law in line with EU practices.</td>
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<td>Build municipal capacity to deal with construction permit issues.</td>
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<td>Create a comprehensive building cadastre.</td>
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<th>Trade Facilitation</th>
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<tr>
<td>Give Customs Administration a larger role in setting customs policy.</td>
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INTRODUCTION:
WHY SERBIA’S GROWTH SHOULD BE EXPORT-LED

Almost invariably strong economies rest on a solid export base, particularly if the range of exports is broad. No country has had rapid sustained annual GDP growth of 7 percent or more for several decades without strongly relying on exports. It is no coincidence that the Growth Commission made exports one of the five key characteristics of economies with a long, strong output growth record (CGD 2008).

Serbia will not be an exception – if it wants a healthy, rapidly growing economy, it must give much more attention to its exports. In the last decade, Serbia’s growth has relied on domestic demand – understandably so, after a decade of turmoil during which the economy did poorly and domestic demand stagnated. In future Serbia could do much better by emphasizing development of exports as a new, potentially powerful, source of growth. The share of exports in Serbia’s GDP, currently only 25 percent, should be double or triple that. The Czech Republic, Hungary, Slovakia, and Poland, all new EU members and countries used as comparators in this report, now all have export shares of GDP 60–80 percent. The point is not that consumption should be cut but that by pushing exports and thus speeding up growth, all components of GDP could grow faster. The economic growth engine would be firing on all cylinders.

Productivity is what determines long-term export and output growth. It is true that accumulation of physical and human capital can contribute significantly to growth. But this is not enough for sustainable rapid long run growth. Factors of accumulation must be used efficiently. Only this leads to a strong rate of growth of total factor productivity (TFP). And it is strong TFP growth that over time results in sustained output growth and high GDP per capita. The reason is that TFP growth creates opportunities for private investors to earn high returns. This attracts new investments, which in turn lead to growth and further boost productivity (Helpman, E. 2004). The message for Serbia, then, is to adopt policies that will promote the rate of TFP growth over the longer term. Also, due to the virtual collapse of the Serbian economy in the 1990s, the utilization of Serbian factors of production is well below pre-1990s levels. This suggests that there is scope for significant one-off increases in productivity as factors of production are better utilized.

The most important determinants of productivity over the longer term are adoption of new technologies and constant improvements in production processes. For these to happen, entrepreneurs need an enabling business environment, capable institutions, regulations that support competition, a skilled labor force, and quality infrastructure. A survey of a large sample of enterprises from six EU countries found that, for every country, export performance of enterprises depends on firm size (medium to large is better), labor productivity, skill intensity, and ability to innovate. Size seems to matter as small firms have a harder time paying the large fixed costs of global operations. To get strong middle and large sized companies, one must start with small ones and have a business environment that helps them grow. Also, while almost 90 percent of the firms in the sample exported something to the EU, very few had significant exports beyond the EU—but those that did, fared better during the recent global crisis (Navaretti, G. et al. 2010). The point is that it is high productivity
enterprises that drive growth rather than country-specific general characteristics, and that the state must help provide the public goods that entrepreneurs need to thrive. It is also the case that highly productive enterprises can better compete in geographically diverse markets. This diversifies their “export portfolio” and makes them less vulnerable to downturns.

This report tries to pinpoint policy actions that would be most effective in raising the rate of productivity growth of Serbia’s enterprises so that better export performance and sustained growth could be achieved. The report has three parts. Part I reviews Serbia’s macroeconomic situation and its progress on structural reforms. Part II starts with a review of the current status of Serbia’s exports and trade policy and regional trade arrangements. It then uses product space (PS) analysis to examine areas where Serbia has a revealed or potential comparative advantage. The report then moves on to two such areas, metal processing and automobile production, which are subjected to value chain analysis to identify bottlenecks that need to be removed for Serbia to become a successful producer and exporter in these areas. Agriculture, another area of comparative advantage, is then covered, with a special focus on what Serbia can do to take maximum advantage of its prospective entry into the EU.

The final part of the report looks at obstacles to more rapid and sustainable development of production and exports. It starts with the analysis of the business environment, based on a range of surveys, which is followed by four sectoral chapters that discuss the obstacles found to be most binding in the business environment: labor skills, power supply and efficiency of its use, use of land, and trade facilitation.

A final but crucial point is that if the economy is to grow at 6–7 percent annually for the next two or three decades, it will take a coordinated, simultaneous push in all the vital areas discussed here, and the macroeconomic environment has to be kept stable. The business environment has to be improved in ways that foster backward and forward linkages across a wide range of industries, not just metals and automobiles. Agricultural policies must be rationalized and the agriculture budget reoriented toward extension services and promotion of supply chains that allow Serbia’s farmers to move up the value chain and be competitive in the demanding EU market. Active labor market programs must be rapidly scaled up, funded, and regularly and rigorously evaluated. Education reforms must be reinvigorated from early childhood to adult learning. Tough reforms in the energy sector must be completed. Construction permits must become much easier and less costly to obtain, the cadastre completed, and the land restitution process wrapped up. Customs and logistics processes must become faster and more predictable. And room must be found in the budget to pay for all these initiatives without losing fiscal discipline.

Half measures will not do. These areas are interconnected, and policies in all areas must be implemented simultaneously in a coordinated fashion, or stagnation in one area will drag down the others. Doing everything at once is of course impossible. But the program, if it is to be successful, has to be ambitious, and priorities must be reset from time to time, depending on progress. The reform program must be designed so that it can be implemented in the existing political environment and adapted to the specificity of Serbia. The few countries that have managed to make the transition
from per capita GDP of less than $10,000 to more than $20,000 all did it through comprehensive, coordinated reforms. Though rare, this is not impossible.

**Entry into the EU is a significant opportunity for Serbia.** It would allow it to join the European “convergence” train. But that will come only with greater integration. The cutting edge of integration for Serbia will be much higher exports of goods and services. That would allow for larger imports leading to higher investment and growth which in turn will lead to higher employment and create room for more consumption, both private and public. As Part II of the Report will detail, Serbia already has a considerable base for a take-off in exports. But a number of challenges must be overcome to turn this potential into reality. That is the subject of Part III of the Report. The report makes the case that Serbia has the potential to overcome its challenges and seize the opportunity.
Chapter 1:
Macroeconomic Environment

1. In the decade up to 2008 Serbia experienced dynamic, but unsustainable, growth. It was fueled by capital inflows and a credit boom that pushed up domestic consumption at the expense of competitive exports. Following the global crisis, Serbia’s lackluster economic recovery, high unemployment and limited export base suggest that it must now shift to a much more dynamic model of growth based on higher productivity, competitiveness, and exports. With productivity-boosting reforms coordinated at the highest levels, Serbia can follow other countries in achieving much higher growth and employment and raising the standards of living for its citizens.

2. A number of the reforms recommended in this report can be paid for by reallocating budgetary funds within the sector. Others will need financing beyond what is currently budgeted. The budgetary envelope needs to make room for these measures without violating the spending and deficit ceiling rules set out in fiscal responsibility legislation. Given the competing demands on the public resources, this will not be easy. The Policy Matrix at the end of the report indicates the rough cost of the suggested policy reforms. Expected costs are either low (€), medium (€€) or high (€€€). Also some expenditures are “one-off” investments with subsequent low maintenance costs, while others, such as ALMPs or some agricultural programs, may require significant resources for some years.

Introduction

3. In the first decade of transition (2000–08), Serbia’s economy grew at an average rate of about 5 percent, driven increasingly by domestic consumption fueled by large capital inflows and a credit boom (Figure 1.1). Growth in domestic consumption was concentrated in nontradable sectors of the economy. Capital inflows and foreign direct investment (FDI), financing a surging current account deficit, resulted in a significant build-up of private external debt, which peaked at about 53 percent of GDP in 2008.

4. When the brakes were put on capital flows and the credit boom with the onset of the global financial crisis, the foundation of Serbia’s growth fell apart. The economy entered recession; real GDP dropped by 3.5 percent and unemployment reached 22 percent. Two years later, Serbia’s growth is
still lackluster, averaging just 1.5 percent annually. Unemployment is still very high, and credit has not grown enough to support sustained economic recovery. Real output is yet to return to its pre-crisis level.

5. **Where does the Serbian economy go from here?** This is the main question of this report. Serbia faces both an opportunity and a challenge. The opportunity is to take full advantage of the European “convergence train” that could eventually carry Serbian incomes up to Western European levels. The challenge is that if this is to happen, Serbia must significantly improve its policy environment and eliminate structural bottlenecks. In effect, it must reinvent its economy. If it is to achieve dynamic, long-run growth, Serbia needs a growth strategy that is much more export-led than has been the case so far.

6. **No single policy intervention will prove to be a “magic bullet” that will make Serbia’s exports more competitive.** Instead, a concerted policy effort closely coordinated at the top level of government is needed to guide a multipronged strategy that will set into motion Serbia’s export growth engine. This will require major structural reforms in many areas—industry, agriculture, education, energy, land use, and in the general business environment. But clearly it can be done. The neighboring Hungary, Czech Republic, and Slovakia have all managed to pump up their exports-to-GDP ratios in a space of 15 years (Figure 1.2). Shifting to growth that is more export-driven will make the economy more balanced, firing on all cylinders of aggregate demand: consumption, investments, and exports. Such a growth model will also be more sustainable but it will require a more attractive investment climate. FDI and foreign know-how would in turn support the new export base.
Serbia’s Pre-crisis Growth Pattern

7. **Serbia's solid though episodic growth in the first decade of transition relied on an unusually benign international environment, significant capital inflows, and a credit boom.** In the first few years of the transition (2000–03), growth averaged 4.3 percent. It then accelerated slightly, to average 5.5 percent in 2004–08 at par with EU10 countries\(^1\) (Figure 1.3). Output rose in real terms by nearly 50 percent between 2000 and 2008 as the corporate and banking sectors began to restructure, expand, and become more profitable.

8. **But growth was driven increasingly by the expansion of domestic demand in nontradable sectors of the economy.** Paradoxically, Serbia did not take advantage of one of the fastest expansions of global trade during this period, instead relying on volatile capital inflows to finance increasingly unsustainable growth in domestic consumption and credit. As much as 85 percent of growth in real value added from 2000 to 2008 was attributable to non-tradables.\(^2\) With annual growth of 11.3 percent, three sectors—retail and wholesale trade, transport and telecommunications, and financial intermediation—were booming; between 2000 and 2008 they contributed three-quarters of total growth. The rest of the economy was growing at just

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\(^1\) EU10 refers to new EU member states that joined it after 2004, but excluding Malta and Cyprus.

\(^2\) In this report the tradable sectors are agriculture and industry (manufacturing, mining, and energy), a large share of whose goods enter foreign trade. All other sectors are considered nontradables.
2.2 percent a year. As a result, the share of nontradables in nonagricultural value-added almost doubled, from 21 to 37 percent. While this shift toward services was not unusual for a country in transition, its speed and scale were exceptional (Figure 1.4).

Figure 1.3: Average real GDP Growth, 2004-08

Figure 1.4: Share of Trade, Transport, and Financial Intermediation in Nonagricultural GDP, EU10 and Serbia, 1996-2008

9. As the crisis in 2008 escalated and international capital markets froze, the weaknesses of its growth model were fully exposed and Serbia was hit hard. With FDI and foreign loans drying up, domestic demand contracted, output dropped, and the dinar depreciated sharply. Because many companies in Serbia had loans indexed to the euro, their interest payments shot up, and company balance sheets got squeezed. Banks were reluctant to lend to the private sector, so new financing was difficult to obtain. Companies were forced to slash costs, and many had to lay off workers—employment fell by over 15 percent, although the contraction of GDP was a relatively modest 3.5 percent).

The Way Forward

10. Countries that have achieved high and sustained growth rates over long periods followed a different path than Serbia, especially with respect to exports. As the Growth Commission Report (2008) documents,
countries that achieved high and sustained growth rates over long periods all shared five common features: (1) they fully exploited the opportunities of the huge world market by ramping up their exports; (2) they maintained macroeconomic stability; (3) they mustered high rates of saving and investment, with most investment covered by domestic saving; (4) they let markets allocate resources; and (5) they had committed, credible, and capable governments.

11. **Balanced growth, relying much more on exports and integration with European and emerging markets, seems to be a promising path for Serbia.** The basic assumption of the growth model of emerging European countries—close integration with the EU—is still sound (Brueghel 2010), but it may require some modifications for Baltic and Balkan countries like Serbia. Those countries should put even more emphasis on trade openness and trade integration. Similarly, the EBRD Transition Report (2010) points out advantages to building up export capacity. Using empirical data, Dollar and Kraay (2002) show the importance of exports, supported by good institutions, for long-term sustained growth. Although both are crucial to growth in the long term, trade is particularly important for medium-term growth. Finally, exports are found to greatly enhance growth prospects through two channels: (i) an increasing returns to scale effect, especially for small economies, when the country can export into a large world market; and (ii) a “stock of knowledge” effect because a country can absorb knowledge developed elsewhere to use in its production (Helpman 2004).

The Medium-term Outlook: Two Illustrative Scenarios

12. **Rebalancing growth sources would help place Serbia on a significantly more rapid and sustainable growth path.** To see whether that is feasible, two internally consistent scenarios were simulated. The starting assumption in both is that the current account (especially trade) deficit must be significantly reduced. The main difference between the two scenarios is in how the necessary adjustment is achieved. In the first, the “high” (export-led) scenario, the adjustment is primarily achieved through successful structural reforms and improvements in competitiveness that provide for high rates of export growth. This in turn accelerates overall GDP growth. In the second, the “low” scenario, the pace of reforms is lackluster and the growth of exports and GDP is lower. Sources of financing of the sort that financed imports (mainly for consumption) in the past decade will most likely not be available over the medium term. While the scenarios are merely illustrative—actual outcomes could fall within or even outside this range—they do suggest a rationale for the policy changes called for here.

13. **The high scenario illustrates the trajectory of the Serbian economy if growth sources are successfully rebalanced.** Here it is assumed that as a result of accelerated structural reforms, and an initial major boost from the
FIAT factory coming online, exports take off vigorously. Nominal growth of exports over the next decade would average close to 16 percent annually. In this scenario, we also assume an increase in investment, peaking at about 28 percent of GDP.

14. **The low, business as usual, scenario illustrates a path with only mediocre growth of exports.** In this scenario, the average nominal growth rate of exports over the next decade is about 11 percent. Consumption, both government and private, grows much more slowly than in the high scenario, and investments hold at only about 23 percent of GDP throughout the period. This slows the growth of imports, so that the merchandise trade deficit also drops below 10 percent of GDP by 2017. However, the narrowing of the trade deficit is the result of sluggish growth, not a shift towards export-led growth.

15. **The growth and export trajectories produced by the scenarios are very different: Serbia reaches much higher growth rates and living standards in the high scenario reflecting forceful reform efforts that produce solid export growth.** Both scenarios result in a sustainable pattern of growth in terms of financing constraints, but there is a large difference in the outcomes. With the “high” (export-led) scenario, GDP (in constant prices) would by 2020 be 80 percent greater than in 2010; the business-as-usual scenario produces only a 40 percent improvement in GDP.

16. **Importantly, the strong reform scenario could generate about 20,000 jobs a year more than the “business as usual” scenario.** In the high scenario, using an employment elasticity of 0.3 (see World Economic Forum 2006), the assumed GDP growth rates would generate 400,000 new (additional) jobs by 2020. If the growth rates continued for another 4-5 years, the unemployment rate could be as low as 5 percent by 2025. In the low scenario, an additional 230,000 jobs would be generated by 2020, but it would take until 2035 (10 years longer than in the high scenario) to bring the unemployment rate to 5 percent. As in the skills chapter (later) the assumption is that there are 90,000 people in each cohort (or 4 million adults aged 20-65) and that Serbia’s goal would be to reach the EU active labor target of 75 percent for all people in that age group.

**Structural Reforms**

17. **Boosting exports to achieve growth that is both sustainable and significant will crucially depend on improvements in competitiveness.** While Serbia clearly progressed early in its transition, “reform fatigue” set in earlier in Serbia than in other transition economies. As Figure 1.5 shows, Serbia’s starting position was on average slightly better than that of the EU10 countries. Early in the transition, soon after 2000, Serbia’s progress was comparable to that of the EU10. However, momentum seems to have been lost relatively early, and since then the pace of reform in Serbia has slackened. As a result, at the end of its first decade of transition, Serbia is
behind the average of the EU10 at a similar point in transition as indicated with light blue dots (Figure 1.6). A policy shift is called for.

**Figure 1.5: EBRD Transition Indicators, 2000–10 for Serbia**

**Figure 1.6: Transition Indicators for Selected Countries, 1999 and 2010**

*Note: T0 is year 1989 for the EU10 and 2000 for Serbia. EU10 = average score for new EU member states, not including the Czech Republic.*

18. **Continued responsible fiscal policy is essential, even though some reforms may be costly.** Many of the measures proposed in this report will require additional public spending. For example, the report proposes increased spending on active labor market programs (ALMPs), expansion of adult training, possible additional incentives to attract FDI, an expansion of agricultural extension services, and the building of agricultural supply chains. There are also costs related to removing serious obstacles to doing business, streamlining trade facilitation, and handling land and energy issues. The fiscal envelope needs to make room for these measures without violating the spending rules and deficit ceilings set out in the fiscal responsibility legislation.

19. **A new and robust model is needed.** Although sustainability could be achieved in various ways, the results of two earlier discussed scenarios suggest that the only model that is both sustainable and achieves stellar growth rates is one that relies on much higher productivity, competitiveness, and exports. This will require dismantling barriers to domestic and foreign investments, boosting competitiveness through sectoral reforms, and a much closer integration with European and global markets. That in turn means...
focusing economic policy on improving the supply side of the economy by reinvigorating stalled reforms. Of course, agreeing on broad, overarching goals and translating them into concrete action is a complex task. This report provides detail and specific advice that will help policy makers to prioritize and design policies that will boost Serbia’s long-term economic prospects.
20. The big opportunity for Serbia is the prospect of EU membership, but there are also other opportunities for it to exploit its revealed comparative advantages. To this end, this part of the report analyzes the current pattern of Serbian exports and suggests sectors where exports could be increased. Chapter 2 looks at Serbian export performance over the last decade, including products and geographical concentration of exports, and reviews Serbia’s trade policies. Chapter 3 presents the findings of a product space analysis that identifies Serbian products that offer the greatest potential for export. Based on the findings of the product space analysis and taking into consideration the history of Serbian economic development, the report zeroes in on two sectors, industry in Chapter 4 and agriculture in Chapter 5.

Chapter 2: Trade Performance and Policy

21. Serbia’s exports grew fast in the first decade of transition, but the share of exports in its GDP is well below that of comparator countries. Average annual growth of goods exports in 2000–10 was about 17 percent in euro terms. As a result, the share of exports in Serbia’s GDP increased from about 15 to 25 percent, far below that of Central and Eastern European Countries (CEEC). The growth of exports resulted from, among other factors, the reopening of the Serbian economy after years of isolation, the restructuring of the real sector of the economy, including some successful privatizations, and the inflow of foreign direct investment (FDI).

22. The growth in exports masks weaknesses that are revealed by a closer look at product and the geographical concentration of Serbia’s exports. The exports growing fastest tended to be low-value-added products: almost two-thirds were raw materials, while consumer goods accounted for just 30 percent (Figure 2.1). Serbia primarily exported metals, plastics, and some agriculture products (Figure 2.2).

23. Almost 90 percent of Serbian exports go to Europe—55 percent to the EU and about one third to the CEFTA region (Figure 2.3). There has been little change in the pattern over the last decade. Within the EU, Serbian

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3 In dollar terms average annual growth rate was about 21 percent.
4 This report uses the Czech Republic, Hungary, and Slovakia as CEEC comparators.
5 CEFTA is a trade agreement between countries in South East Europe that has replaced bilateral agreements between Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Moldova, Montenegro, Serbia, and UNMIK/Kosovo.
exporters mainly trade with the old EU member states (EU15), though this has been changing in recent years (Figure 2.4). Overall, the EU share has been marginally declining and the CEFTA share taking up the slack. Such geographical concentration makes Serbia highly sensitive to economic developments in Europe. Therefore one policy recommendation would be to explore options for further expansion of exports to other emerging markets, outside Europe.

Figure 2.1: Trade by Broad Economic Categories

Source: NBS

Figure 2.2: Trade by SITC Classification

Source: NBS

Figure 2.3: Destination Averages, 2004–08

Source: NBS.

Figure 2.4: Destination Shares, 2001 and 2010

Source: NBS.

24. **Exports of services could gain in importance.** Even though this report does not discuss services, they may become more important for Serbia’s external position. Over the last five years, Serbia annually earned €2.4 billion (US$3.3 billion) from service exports. Pre-crisis they grew 33 percent annually before declining by 13 percent in 2009. Thus, their share in GDP nearly

6 These countries are: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and United Kingdom.
doubled over the previous decade, from 5 percent of GDP in 2001 to 9.2 percent in 2010. But the net effect on Serbia’s current account was close to zero, because services imports were also growing fast. The share of service imports in GDP has nearly tripled since 2001, from 3.2 percent to 9.2 percent. As a result, from 2005 to 2008 Serbia had a negative balance in trade in services that averaged 0.4 percent of GDP a year, though for the last two years trade in services was again balanced.

25. **Serbia has liberalized its foreign trade policy significantly.** Since the transition began in 2001, Serbia has introduced a number of measures that demonstrate its commitment to opening up its market to foreign goods and tapping into opportunities abroad. Liberalization of the foreign trade regime, with deregulation of trade, was one of the pillars of post-2000 reforms. In the first two years of transition Serbia halved its tariffs and started negotiating free trade agreements. Currently, it is a signature party to CEFTA and has favorable bilateral trade agreements with the EU, Russia, countries of EFTA, Turkey, Kazakhstan, and Belarus. Since 2004, Serbia has been working on accession to the WTO and entered the final accession stage in October 2010.
Chapter 3:
Which Products Could Serbia Export?

26. **What exports should Serbia develop?** One way is to let the market decide, but that is not the road most of today’s emerging exporters have taken. Typically, they adopted a strategy. Serbia should do the same. The Product Space analysis offers a data-driven way to evaluate the feasibility and desirability of sectoral transformation options. On the basis of detailed data on global trade and GDP per capita by country and time period, it generates insights about links between sectors and sector priorities for production and exports.

27. **The PS analysis recognizes that as economies mature, they experience a process of structural transformation that typically goes from agriculture to manufacturing and services.** During this process, economies acquire the capacity to utilize new inputs of production to deliver and create more sophisticated products and services. Every new product or input adds complexity to the pre-existing network of economic activities.

28. **Complexity of interlinkages among various products that are exported can be presented by a map showing a network of products in the product space (PS).** While some inputs are used for the production of a large number of products, others are specific to particular production processes. Recognizing that similar products require closely related inputs, Hausmann, et. al. (2006) proposed to use the relatedness in the inputs of production to present the proximity among exporting products (based on cross-country evidence). This was the foundation for constructing a map (network) that represents the global PS. Such a map also serves to demonstrate that as economies advance they move towards areas where proximity among products is greater – i.e., they move to the densest part, the core, of the PS.

29. **The PS analysis generates empirical measures that provide clues to what a country’s export strategy might be.** These measures are constructed using cross-country similarities in revealed comparative advantage (RCA) of goods that are traded and the income (value-added) levels associated with exporters of specific products. The PS analysis recognizes that a country wants to follow a diversification strategy that, while based on its current comparative advantage, leads it into new product categories where the scope for diversification is greater and which hence can lead to higher incomes.

30. **The PS methodology can be applied in steps.** Accordingly, this report relied on a stepwise approach using country-specific data for the period 1995-2010 to generate recommendations on possible options for export diversification and expansion. First, on the basis of the RCA time series data, products in the country’s existing export basket are divided into four groups according to long-term shifts in RCA: classics, emerging champions, marginal,
and disappearing (see definition in Table 2.1). Then the PS metrics (characteristics of density, path and PRODY) are used to identify the best prospects for export diversification. Products that, in addition to an RCA greater than 1, have a higher “density” (more probability of acquiring an RCA>1 in a related product); larger values of the “path” (products with larger values are closer to the PS core); and a higher “PRODY” (a measure, proxied by GDP per capita of countries that already export this product, that suggests that a country capable of exporting this product will generate a higher income) are those which a country could look into as a source of increased export revenues.

31. **Cross-country evidence suggests that there is a trade-off between products that are within reach (higher density) and those that are more profitable.** Policy makers and analysts are thus forced to choose, because generally there is a negative relationship between the concepts of density and PRODY, and between the density and the path, and an overall positive relationship between the PRODY and the path. In other words, products that are potentially more profitable are harder to move into (lower density), while nearby (easy to move into) products have a limited scope for diversification and growth.

32. **The four groups of products: classics, emerging champions, marginal, and disappearing, are presented on a world PS map** (Figure 2.5), where Serbia’s 237 export products (colored symbols) are mapped against a background (grey symbols) of all goods traded in the world (over 700 product categories). Grey dots that are close together and toward the center of the picture tend to represent more complex, interrelated goods (such as machinery, pharmaceuticals, and electronics) that are harder to produce but more profitable. When the dots are away from the center, the products are less sophisticated, such as raw materials. Clearly, Serbia has some way to go to produce a high-value-added export basket that would contain product categories close to the core of the PS. A PS map for all the goods traded in the world identifies the various groups in some detail (see also Annex 2 of the PS chapter in Volume 2).

Figure 2.5: Serbia’s Position in the Product Space
33. **Serbia’s export structure, using the four-way classification scheme of products (classics, emerging champions, disappearing and marginals) is presented in Table 2.1.** Combined, the four groups of products in the PS analysis include 237 products and account for about 80 percent of Serbia’s total exports. Classics and emerging champions account for nearly 70 percent. The column Path in Table 2.1 indicates that on average, classical exports offer slightly less possibility of further diversification than emerging champions or marginals. The differences are larger when their income potential (PRODY) is compared; for classics it is much lower than for emerging champions and marginal products. In terms of ease of diversification, emerging champions, as expected, have higher densities than marginals. Yet the fact that emerging champions comprise about a half of Serbia’s export basket suggests that Serbia is producing increasingly sophisticated products. Not surprisingly, disappearing products have very low densities and are far from the PS core (low path value).

<table>
<thead>
<tr>
<th>Product Classification</th>
<th>Number of Products</th>
<th>Exports (percent of total)</th>
<th>Average PRODY</th>
<th>Average Path</th>
<th>Average Density</th>
</tr>
</thead>
<tbody>
<tr>
<td>Classics</td>
<td>34</td>
<td>17.6</td>
<td>10,405</td>
<td>138</td>
<td>0.40</td>
</tr>
<tr>
<td>Emerging</td>
<td>102</td>
<td>51.6</td>
<td>13,291</td>
<td>144</td>
<td>0.39</td>
</tr>
<tr>
<td>Marginal</td>
<td>81</td>
<td>7.9</td>
<td>19,277</td>
<td>144</td>
<td>0.34</td>
</tr>
</tbody>
</table>
Disappearing 20 43.9 13,476 127 0.33
Excluded 71 19.0 16,328 130 0.31

Notes: Classics are products with RCA>1 in both periods 1995–99 and 2005–09. Emerging champions are products with RCA>1 from 2005-09, but not earlier. Disappearing products had RCA>1 during the period 1995–99, but RCA<1 by 2005-09. Marginals did not have RCA >=1 in either period, but have relatively high PRODY and density. Excluded products had an RCA < 1 in both periods as well as either low PRODY or low density.

Source: World Bank staff calculations.

34. The PS analysis can help to formulate the short, medium, and long-term strategies for export diversification. The basis for a short-term strategy is to support traditional exports with strong linkages to more sophisticated activities. Serbia’s main classical exports are vegetables, fruits, cereals and sugar in the food and agro-processing industry; traditional iron and metal manufactures, and apparel and clothing. The aim of the medium-term strategy should be to scale-up those existing income-enhancing options, i.e. emerging export products. This group is comprised of sectors with a large number of emerging champions such as non-traditional exports of iron and metal manufactures, including non-ferrous metals, auto-related products such as pneumatics (rubber products), artificial resins (paper) and plastic materials. A longer-term strategy should remove the binding constraints for those sectors with a large number of marginals, with strong linkages to classics and emerging champions, and with high income-enhancing potential, such as the auto-related sector (see Table 2.2).

35. A more detailed analysis was conducted for food-processing, metals, and automobiles (see Volume 2). The first two were chosen because a significant portion of Serbia’s current export basket is in those areas. The third was selected because of the large ongoing investment by FIAT in the Serbian auto industry. This analysis indicates that Serbia is in a good position in food-processing; its exports of such goods have grown at least as much as those of Bulgaria, Croatia, Romania, and Slovakia, though not as much as those of Hungary or the Czech Republic. In metal manufacturing Serbia’s position indicates that it has space to scale up, although the total value is twice as high as that of food-based exports. However, by increasing the share of emerging exports and building on marginal products, Serbia should be able to increase the overall sophistication of its export basket. This should create production linkages to more complex activities, such as those in the auto industry.

Table 2.2: Product Space Metrics for Selected Serbian Exporting Industries

<table>
<thead>
<tr>
<th>SITC Category (2-digit)</th>
<th>Classics</th>
<th>Emerging</th>
<th>Marginals</th>
<th>Exports (%)</th>
<th>Average PRODY</th>
<th>Average Density</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metal Manufactures</td>
<td>5</td>
<td>13</td>
<td>12</td>
<td>23.5</td>
<td>16,965</td>
<td>0.351</td>
</tr>
<tr>
<td>Auto-related products*</td>
<td>0</td>
<td>6</td>
<td>7</td>
<td>3.9</td>
<td>19,659</td>
<td>0.344</td>
</tr>
<tr>
<td>Food and Agro-Processing</td>
<td>9</td>
<td>12</td>
<td>8</td>
<td>11.3</td>
<td>13,539</td>
<td>0.389</td>
</tr>
<tr>
<td>Organic chemicals</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>1.4</td>
<td>19,893</td>
<td>0.353</td>
</tr>
<tr>
<td>Artificial resins and plastic materials, and cellulose esters etc</td>
<td>1</td>
<td>3</td>
<td>3</td>
<td>2.8</td>
<td>18,201</td>
<td>0.344</td>
</tr>
</tbody>
</table>
Success with the export diversification and expansion strategy significantly depends on government’s ability to help to resolve some of the remaining sector specific obstacles. In order to understand what are the main sector specific obstacles for increased competitiveness of the most promising export sectors in Serbia the report relied on a value chain analysis (VCA). VCA done for the purpose of this report covered metals industry (a sector which has the highest share in total export and highest number of promising export goods) as well as automotive industry (a sector which is expected to provide significant export revenues in the near future). Some of the key findings include that in each of the two analyzed sectors there is a dominant producer with only limited linkages with other participants from the sector. Reasons for limited integration of domestic producers are numerous but to large extent stem from the fact that various domestic companies to not meet international standards in their production processes.

Source: Authors' calculations
Note: Auto-related product category was generated using PS metrics. See Volume 2 for details

36. It’s findings are summarized in the next chapter and in much greater detail it is presented in the Volume 2 of this report.
Chapter 4: Industry

Introduction

37. This chapter reviews government policies to promote competitiveness and exports and highlights how competitive Serbia’s industry is compared to other countries in the region. The chapter also takes another look at the metals and auto industry, but from the “bottom-up” perspective using a value-chain analysis. Complementing the previous analysis from the “top-down” – PS angle, the conclusion is that there remains a comparative productivity and competitiveness problem in Serbia’s manufacturing. Yet there is also considerable potential for synergies, not only to generate export growth and penetrate EU markets but also to expand domestic value chains. The last would encourage growth of SMEs.

38. One of Serbia’s biggest problems is its low level of exports. While its position as a potential candidate for EU accession has increased its market opportunities, the enterprise sector must first deal with several challenges. As outlined in Chapter 3, it is encouraging that emerging champions compose half of the export basket because that suggests increasing market sophistication. However, Serbia must do even better if it is to catch up with regional competitors like Hungary, Slovakia, and Czech Republic.

39. For the past decade, the Serbian government has been using comprehensive privatization as a cornerstone of its industrial policy. Between 2002 and 2010 most SOEs went through the privatization process, which attracted significant brownfield FDI. Over 2,400 SOEs were put up for sale through public tenders and auctions and another 700 were privatized through the capital markets.

40. A striking feature of Serbia’s enterprise structure is the “missing middle” – the lack of dynamic middle-sized companies that could make a significant economic contribution. Resources are heavily concentrated in a relatively small number of large companies that have less than average productivity. There are also numerous small and micro companies that have not been able to grow to medium size and achieve the economies of scale necessary to become competitive exporters.

41. To become more competitive internationally, the government recently launched its Strategy and Policy for Development of Industry to define priorities for the next decade. This Strategy is directed to export growth, increased investment, and job creation. Industries targeted for growth

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8 Companies are categorized based on number of employees. Micro companies have up to 10, small companies 10 to 50, ‘medium’ companies 50 to 250, and large companies more than 250.
in exports are food, transportation equipment, information and communications technology, metals, and pharmaceuticals.

The Enterprise Sector\(^9\) in Serbia

42. **Serbian companies are less productive and their unit labor costs are higher than those of other firms in the region.** Workers in Serbia produce less than half of what workers in Slovakia produce and just over half of the output of workers in Czech Republic and Hungary. However, their wages are not sufficiently low to compensate for this. As a result, unit labor costs in Serbia are significantly higher than in the other countries (Table 2.3)

Table 2.3: Productivity and Unit Labor Costs Compared

<table>
<thead>
<tr>
<th>Country</th>
<th>Worker Productivity* (EUR)</th>
<th>Unit Labor Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>23,548</td>
<td>0.37</td>
</tr>
<tr>
<td>Hungary</td>
<td>20,812</td>
<td>0.42</td>
</tr>
<tr>
<td>Poland</td>
<td>18,527</td>
<td>0.36</td>
</tr>
<tr>
<td>Romania</td>
<td>12,544</td>
<td>0.38</td>
</tr>
<tr>
<td>Slovakia</td>
<td>25,043</td>
<td>0.32</td>
</tr>
<tr>
<td><strong>Serbia</strong></td>
<td><strong>12,837</strong></td>
<td><strong>0.54</strong></td>
</tr>
</tbody>
</table>

Source: Eurostat, Serbian Agency for Business Registries * Value added per worker.

43. **Although the number of micro and small enterprises vastly outnumbers the number of large enterprises, the latter dominate in terms of revenues, value added, and employment** (Table 2.4). Yet both have higher labor productivity and lower unit labor costs than medium-size companies. There seems to be a problem in the middle. This “missing middle” suggests that there are growth ceilings for small enterprises—probably related to weaknesses in Serbia’s business environment (see Chapter 6).

Table 2.4: Serbia: Industrial Structure

<table>
<thead>
<tr>
<th>Company Size by Number of Employees</th>
<th>Number of Companies 2009</th>
<th>Employment (percent) 2009</th>
<th>Revenues (percent) 2009</th>
<th>Value Added (percent) 2009</th>
<th>Labor Productivity 2007-09(^9)</th>
<th>Unit Labor Costs 2007-09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro (0–9)</td>
<td>82,435</td>
<td>19.7</td>
<td>16.3</td>
<td>13</td>
<td>797</td>
<td>0.37</td>
</tr>
<tr>
<td>Small (10–49)</td>
<td>9,148</td>
<td>17.6</td>
<td>21.7</td>
<td>19.2</td>
<td>1,216</td>
<td>0.42</td>
</tr>
<tr>
<td>Medium (50–249)</td>
<td>2,457</td>
<td>22.5</td>
<td>22.3</td>
<td>19.7</td>
<td>947</td>
<td>0.65</td>
</tr>
<tr>
<td>Large (&gt;250)</td>
<td>533</td>
<td>40.2</td>
<td>39.7</td>
<td>48.1</td>
<td>1,260</td>
<td>0.59</td>
</tr>
<tr>
<td>TOTAL</td>
<td>94,573</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>1,093</td>
<td>0.54</td>
</tr>
</tbody>
</table>

Source: Agency for Business Registries, Statistical Office, WB staff calculations

\(^9\) In this text enterprise sector refers to all companies that report to the Agency for Business Registries.
# Value added/worker in '000 dinars

Competitiveness in the Metals and Automotive Industries

**Metals**

44. **The metals industry is dominated by the production of a single company, US Steel.** The industry is a prime example of the missing middle phenomenon: the 10 largest companies account for over 77 percent of all sector revenue.

45. **Serbia exports virtually all of its steel and in 2010 accounted for 0.09 percent of global crude steel production.** In 2010 steel was Serbia’s top export product. Valued at slightly over $1.3 billion, it represented over 13 percent of total exports. However, Serbia’s steel exports are highly sensitive to global output trends because they consist mostly of low value-added products with little avenue for differentiation. The Serbian steel industry manufactures mainly primary and intermediate steel products, among them both of the major primary products, flat steel and long steel, made from iron ore. Steel can also be produced from recycled scrap metal. Several small foundries in Serbia have smelters supplied by scrap sourced both domestically and abroad (see Figure 2.6 for the steel value chain).

![Figure 2.6: Steel Value Chain](image_url)
46. **Serbia’s steel exports are low-value-added.** Figure 2.7 shows how value is added at each stage of metal production up to manufactured products. Serbia produces mainly hot and cold rolled coils, though some pipes are exported. It does not export structured steel and yellow metals where the bulk of the value is added. Since Serbia has no iron ore, raw materials tend to be imported, processed, and then exported still in a relatively simple form.

![Figure 2.7: Value Added at Each Stage of Steel Manufacturing (Percent)](image)

47. **Some SMEs manufacture small quantities of high-value-added steel products.** A few firms produce intermediate steel products that are inputs to white goods and appliances. Several others manufacture finished steel goods: rods, angles, plates, cast items, tubes, pipes and hollow profiles, household articles, and radiators.

48. **A revenue/cost analysis of the steel industry indicates that:**
   - Core profitability has been marginal or negative for most of the Serbian steel industry for the past three years.
   - Energy costs have a moderate impact on the competitiveness of most steel companies but a much more significant impact on U.S. Steel Serbia.
   - Changes in raw materials prices are determined by global supply conditions and passed through to buyers.
   - Personnel costs are a small fraction of total production costs.

**The Automotive Industry**

49. **Serbia’s automotive manufacturing history dates back over 80 years.** Zastava, producing a version of a FIAT car, was the biggest automobile manufacturer in Yugoslavia. It had to significantly reduce production because of the conflict and accompanying sanctions. While production has since resumed, technology in most of the plants has not
advanced significantly. To reactivate the Zastava plant and reenergize the industry, the government has attracted FIAT, which will invest in a major original equipment manufacturer (OEM) production facility. It will also retrain the workers. Similar efforts by the Slovakian government to attract automotive FDI yielded significant rewards for its economy (see the Industry chapter in Volume 2).

50. **FIAT has the potential to transform Serbia’s automotive industry, and others.** The company is bringing in its own group of Tier 1 suppliers, which represent a huge opportunity for building backward links to domestic suppliers (Tiers 2 and 3). To harness these opportunities, there is a need to actively develop the automobile cluster. Getting FIAT to invest in Serbia is a major accomplishment and some Tier 1 suppliers may enter into Serbia trusting that the rest of the supply chain will fall into place through regular market forces. But FIAT can also source its supplies on a purely commercial basis from abroad, without any local supply chain requirement. Creating these backward linkages requires concerted effort.

51. **The main messages from a revenue/cost analysis of the automotive sector are that:**

   - The industry is concentrated because of the sheer size of FIAT, which already accounts for 52 percent of total sector earnings.
   - Core profitability in the automotive industry is slightly positive at 103 percent in 2009 and 101 percent in 2010.
   - Energy prices have only a moderate impact on competitiveness. Energy and fuel costs accounted for 3 percent of total production costs in the automotive industry in 2010.
   - Raw materials are the major cost driver, accounting for 66 percent of total production costs for the nine large firms in the industry.
   - Wages take up a significant share of costs, especially for SMEs.

52. **The metals and the automotive industries are important to the economy of Serbia in different ways.** Figure 2.8 shows where U.S. Steel and FIAT are positioned in their value chains: U.S. Steel, Serbia’s dominant steel producer, is near the bottom of the global and national value chain. It uses raw materials to produce semi-finished and finished goods which are used for further manufacturing. FIAT is at the top of the value chain. It produces high-value-added finished goods for export around the globe. Their positions lead to very different implications for policies that would best support development of the two industries.

Figure 2.8: Value Chain Positions of U.S. Steel and FIAT
U.S. Steel offers potential for forward linkages in the economy, particularly to SMEs producing higher-value-added steel products. Policy interventions in the metals industry should therefore be focused primarily on providing incentives and removing obstacles that might hinder US Steel from upgrading its products or selling inputs to domestic producers of higher-value-added metal products.

On the other hand FIAT offers potential for backward linkages with local automotive suppliers. According to the OECD, backward linkages account for twice the value-added in the automotive industry (OECD 2009). Therefore an option for policy interventions in the automotive industry could be to support capacity building by providing adequate education and active labor market programs in order to help to get domestic automotive suppliers to the level required first by Tier 1 and 2 suppliers with the eventual goal of supplying OEMs like FIAT.

Synergies Between the Metals and Automotive Industries

Because automotive components are in many ways an extension of the metals chain, there is great potential for backward linkages. Steel comprises 55 percent of the value of an average automobile. The primary
areas for synergies in the automotive value chain would be linking Tier 3 suppliers that produce basic materials such as flat rolled sheets to Tier 2 suppliers that produce individual parts. This was also shown by the PS analysis, with the greater number of emerging champions and marginals concentrated in the metal manufacturing and auto-related production (see Table 2.2).

56. However, promoting synergy between the automotive and steel industries is not just a matter of having a base metals industry in the country. The type of steel the automotive industry needs is very specific. Most of the steel currently produced in Serbia is not processed to automotive industry requirements. Local industry experts estimate that the automotive industry should be able to source about 15 percent of its supplies within Serbia based on products currently being produced.

57. The steel industry will need to continually upgrade if it is to meet the increasingly stringent requirements of the automotive industry. New lightweight advanced high-strength steels have the potential to reduce automobile energy consumption by 50 percent over the life cycle. In the automotive industry, 60 percent of the steel grades used today were invented in the last five years. New steels make possible thinner components that reduce weight but also increase safety for drivers and passengers.

58. Serbia cannot remain competitive in either industry in the long term unless it develops competitive advantages anchored in quality and improved technology. Serbia’s cost competitiveness cannot match those of Asian competitors because of its limited production scale. Thus, the necessity for innovation cannot be overstated. With an established metals and automotive industry and a high quality educational system (including TVET and good adult education), the country could have a unique opportunity to leverage that base to produce next-generation products.

Policy Recommendations

Orient public policies toward developing coherent inter-connected clusters to maximize economic spillovers.

- In the metals industry, encourage forward linkages by removing any disincentives to trade between different domestic manufacturers.
• *In the automotive industry*, promote backward linkages. Consider a government automotive industry action plan to bring domestic Tier 2 suppliers of aftermarket products into the automotive value chain.

**Target high value-added FDI.**

• *In the metals industry*, attract companies that require inputs produced by U.S. Steel for a quick win.
• *In the automotive industry*, court other OEMs to help upgrade local capabilities and prevent competition problems arising from having FIAT as the only local buyer.

*Promote public-private partnerships, cooperation and investments in Research and Development.*
Chapter 5:
Agriculture

Introduction

59. **There is general agreement that the potential of agriculture for improvement is massive.** In the not-so-distant past, Serbia was a major exporter of agricultural goods. In recent years, Serbia has become a net food exporter again, but its exports could be much higher. The extension service could be made more effective by finding ways to change the behaviors of hundreds of thousands of farmers. Supply chains could be improved through government assistance in setting up wholesale markets, cold-store facilities, packing plants and milk laboratories. Trade could be liberalized further and the costs of trade (customs, logistics and transport) further reduced. Budget could be reallocated away from area payments to initiatives such as those mentioned above, where they could lead to higher overall returns to farmers. Not least, unpredictable policies and a lack of attention to structural reforms are making it hard for farmers, processors, and traders to plan ahead. Yet there are major opportunities they could seize both within and beyond the EU.

**The Gap Between Potential and Performance**

60. **The importance of agriculture to Serbia’s economy is widely recognized.** In almost all local, regional, and national strategies, agriculture has been flagged as an area for development. Agriculture has not only great economic and social importance but also high political significance because so many Serbian citizens live in rural areas. Thus, because often agricultural policies appear to be driven more by political than by economic concerns, they are often inefficient in terms of reaching Serbia’s development goals.

61. **The potential for improvement is massive.** According to studies, milk yields could be doubled, cereal yields increased by 50 percent, and gross margins doubled. Serbia’s export value per hectare (ha) of farmland is lower than that of almost every other country in Europe. By increasing yields, controlling costs, switching to higher-value products, and adding value through processing and marketing, Serbia’s food sector can dramatically increase its output value, export value, and profit. The potential benefits from achievable improvements are probably greater than the total support the sector will receive from the CAP.

62. **The restructuring of the sector, liberalization of trade, and particularly the access to EU markets, have allowed Serbia to become a**
net food exporter starting in 2005, when the sector had a surplus of about US$ 255 million. By 2010 agro-food exports amounted to over US$1 billion. However, Serbia is still far from exploiting the full potential created by its natural conditions, location, and trade access.

63. **Growth is held back by unpredictable policies that make it impossible for farmers, processors, and traders to plan ahead.** Participants in the agriculture market chain are not getting a clear message from the policy makers. Policies are often characterized by short-term ad hoc measures so that market participants find it impossible to plan ahead. Each short-term action may solve an immediate problem but also create long-term problems and confusion in the market. Instead of building market awareness, circulating market information, protecting competition, enforcing contracts, and upholding the rule of law, the state interferes in the operation of markets through, e.g., issuing pronouncements on expected prices, releasing lower-priced products from commodity reserves, or introducing export bans.

64. **Prices are more volatile in Serbia than in the EU.** Many agricultural and food products show high volatility, with Serbian prices rising higher than EU prices when there are shortages and dropping below EU prices when there are surpluses (see Volume 2 for more details). This volatility, which suggests a lack of competition and efficiency in marketing chains, makes it difficult to achieve a continuity of exports, as well as having obvious negative effects on consumers.

**Structural Challenges**

65. **Market development is changing the structure of farming; a commercial farm sector is gradually emerging.** Serbia is seeing an increasing divide between commercial farms that are taking advantage of modern agricultural technology and markets, and many small farms that still produce in traditional ways and either market through informal channels or supply to processors from a weak bargaining position.

66. **Serbia’s food processing industry is underdeveloped and uncompetitive, which seriously impairs its ability to export to the EU.** Serbia has a very large number of primary producers and an underdeveloped food processing sector that has not yet been able to penetrate European supermarkets. If Serbia wants to increase the value of its food production and exports, it will need a better-organized marketing chain and investments in storage and food processing.

67. **Informal markets are a major force.** Products consumed on farm or marketed locally substitute for imports and make a highly significant contribution to the balance of payments, as well as contributing to household income and food security of some of the poorest members of society. One of the challenges is how to preserve the strengths of this traditional system while
developing the processing and marketing chains required for long-term competitiveness within the EU.

68. **As consumer demand in Europe changes, Serbia must be prepared to meet new expectations for food safety, quality, and origin.** European consumers are increasingly concerned about food safety, ecologically conscious, and oriented toward local products, so there is more differentiation between products that sell on price and those that compete on quality. Because these trends are less advanced in Serbia, producers and processors find it hard to understand the needs of their customers abroad. Therefore, if they are to gain entry to the more lucrative EU markets, policy makers in Serbia must take a lead and offer producers the opportunity to certify their products under one of the international standards.

69. **The cereal production is more important in Serbia than elsewhere in Europe, and the livestock production is declining.** The share of cereals in total production value in Serbia, encouraged by the recent (and expensive) area payment system, is 34 percent, versus 11 percent in the EU (Figure 2.9). Meanwhile the livestock output is declining rapidly in response to international competition.

![Figure 2.9: Share of value of production of selected sectors in 2009](image)

70. **The pre-accession period requires great adjustments and investments at all levels of agriculture and food industries.** Farmers have the biggest difficulties on the road to the EU membership but they are also the ones who will profit the most upon joining. A significant part of the costs of
adapting Serbia's agriculture to the Common Agriculture Policy of the EU are borne by all citizens, as taxpayers, while the biggest benefits will accrue primarily to farmers.

Policy Responses

71. **Uncertainties with agricultural policy and declining public spending have discouraged investment.** Serbia has redesigned its agricultural policy every two years since 2000, leading to an unstable policy environment. In addition, the share of public expenditure devoted to the agricultural and food sector has been halved, from 5 percent in 2004 to 2.5 percent in 2010 (3.2 percent once own revenues of the Ministry of Agriculture are included, see Table 2.5). The agriculture budget as such is no longer sufficient for government to fulfill its tasks adequately.

Table 2.5: Serbia Agricultural Budget, RSD millions, 2004-2010

<table>
<thead>
<tr>
<th>Year</th>
<th>Total budget of the central government</th>
<th>Agricultural budget</th>
<th>Percentage of total</th>
<th>Own revenues</th>
<th>Own revenues as % of total</th>
<th>Total budget available</th>
<th>Percentage of total budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>362,045</td>
<td>18,060</td>
<td>5.0%</td>
<td>2,085</td>
<td>0.6%</td>
<td>20,145</td>
<td>5.6%</td>
</tr>
<tr>
<td>2005</td>
<td>400,768</td>
<td>16,270</td>
<td>4.1%</td>
<td>2,714</td>
<td>0.7%</td>
<td>18,984</td>
<td>4.7%</td>
</tr>
<tr>
<td>2006</td>
<td>505,821</td>
<td>23,593</td>
<td>4.7%</td>
<td>3,950</td>
<td>0.8%</td>
<td>27,544</td>
<td>5.4%</td>
</tr>
<tr>
<td>2007</td>
<td>595,518</td>
<td>21,410</td>
<td>3.6%</td>
<td>4,686</td>
<td>0.8%</td>
<td>26,096</td>
<td>4.4%</td>
</tr>
<tr>
<td>2008</td>
<td>695,959</td>
<td>27,634</td>
<td>4.0%</td>
<td>5,261</td>
<td>0.8%</td>
<td>32,895</td>
<td>4.7%</td>
</tr>
<tr>
<td>2009</td>
<td>719,854</td>
<td>15,964</td>
<td>2.2%</td>
<td>10,726</td>
<td>1.5%</td>
<td>26,690</td>
<td>3.7%</td>
</tr>
<tr>
<td>2010</td>
<td>797,498</td>
<td>19,908</td>
<td>2.5%</td>
<td>5,714</td>
<td>0.7%</td>
<td>25,622</td>
<td>3.2%</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance of the Republic of Serbia

72. **Current government agricultural support programs do little to achieve Serbia’s strategic objectives for the sector, extension services are wholly inadequate and supply chains undeveloped.** Over 80 percent of total expenditure is on area payments, which are focused on specific groups of farmers based on the size (mainly small-scale farmers), production (especially crop production), and region (Vojvodina) where the majority of arable land and such production are concentrated. This support increases income disparities between farms and regions. It distorts the production pattern by giving little encouragement to the high-potential fruit and livestock sectors. Extension services are poor and inadequate storage and processing
facilities make for weak supply chains, which hold back agricultural supply response.

73. **High tariff protection encourages Serbian farmers to produce import substitutes rather than exportable goods.** The bilateral and multilateral trade agreements signed in recent years have helped to reduce these negative effects, but they are still significant. Further, export subsidies provide a financial benefit only to a few exporting companies, not the sector as a whole.

74. **Efforts of the Directorate of Commodity Reserves (DCR) to stabilize market prices are no longer realistic or appropriate.** The DCR pursues two rather different objectives: maintain strategic stocks in case of war, natural disaster, or other disruption to supply; and stabilize domestic prices by intervening in commodity markets. This was a useful role during the era of conflict and sanctions, when it built up stocks in periods of high supply and low prices and released them to the market when supply was short and prices high. More than a decade later, the DCR continues to play that role, despite the major changes in Serbia's political and trading relationship with the rest of the world. The goal of stabilizing domestic prices is practically not achievable in an open economy, since whenever an intervention body starts buying to raise prices, imports increase and push prices down again; and when it starts to release stocks to bring prices down, exports increase and prices go up again.

75. **Keeping stocks for food security reasons also has to be reconsidered.** Domestic food security based on food reserves was a reasonable strategy in times of socialism and when the country was less integrated in the world economy. At present, when Serbia has many trade agreements and is well on the way to becoming an EU member, the risk that it will suddenly find itself unable to import vital food stocks is considerably lower. On the other hand, there may be new risk factors, such as extreme weather events or terrorist actions, that should be taken into account when determining the level, nature, and location of emergency stocks.

**Policy Recommendations**

Government would be well-advised to intervene only in areas where there are significant market failures and the probability of government failure low. Market failures will be easier to identify if government policy is based on evidence and analysis of underlying problems. Careful analysis should also help reduce the frequency of policy changes and thus reduce the uncertainty faced by farmers.

Recommendations to enhance agricultural productivity are the following:
1. **Make the policy process more predictable, particularly by clearly defining the role of government.** This will reduce uncertainty, increase investment, and thus speed up sector restructuring.

2. **Build an effective extension service.** Fulfilling Serbia’s large agricultural potential will require changes in the behavior of hundreds of thousands of farmers. Extension is vital for promoting such change. The government should act decisively to ensure that the extension service adheres strictly to its core mission of helping farmers to become more competitive and that it is not sidetracked into administering agricultural subsidies and grant schemes.

3. **Improve the supply chains.** Supply chains are an area where market failure is common and effects of investments in linkage phases (storage, packaging, processing, and transport) are strong. Such investments can stimulate exports and transmit benefits all the way down the supply chain to the small-scale farmer. Because massive investment is needed to bring supply chains up to international standards, government needs to create adequate environment to allow for such investments, provide support when absolutely necessary and explore the options to utilize EU-funded IPARD resources.

4. **Continue with trade liberalization.** Serbia should resist the temptation to apply ad hoc trade bans, licensing systems, or non-tariff barriers as quick fixes of short-term problems. Serbia may want to abolish export subsidies as soon as possible; the practice is both disruptive and costly.

5. **Replace the DCR with EU-compatible mechanisms.** The Directorate should be released from its role of market stabilization, and instead be asked to prepare for the implementation of the CAP’s “Common Market Organisation”. The Government would be well-advised to reduce price volatility through enhanced trade, Serbia’s integration with regional markets, and through the development of commercial risk-management systems, such as forward and futures trading. Maintaining strategic reserves against political or natural disasters should be separated from regulating markets.

6. **Revise the agricultural budget and its allocation.** At less than 1 percent of GDP, the present agricultural budget is not only small by international standards, but its share in Serbia’s budget has also declined. In the next few years Ministry of Agriculture must prepare the agricultural and food sector for EU integration and WTO accession. It will almost certainly require a larger budget if it is to fulfill Serbia’s expectations for the sector. But even more urgent and more important than increasing the budget is reallocating existing resources. Reallocating of funds from costly and ineffective area payments and milk subsidies is the most immediate way to finance essential investments in institution building and providing essential public goods, such as making the extension service more effective and building the supply chains.
Chapter 6: The Business Environment

76. In recent years, numerous reforms have streamlined procedures to open and close businesses, improved access to credit, strengthened the laws governing competition policy, and improved contract enforcement. For example, today starting a new business takes 13 days and costs 7.9 percent of income per capita, compared to 56 days and 15 percent in 2005. The BEEPS surveys show that managers recognize improvements in the courts, tax administration, business licensing and permits, and labor and trade regulations. Yet while this was going on neighboring countries were improving their investment climates even faster, so Serbia still lags behind them in Doing Business 2011.

77. One particularly problematic area is the onerous process of securing a construction permit, where Serbia ranks among the bottom 10 countries in the world. Logistics, infrastructure, and skills, too, are serious constraints on the investment climate. BEEPS enterprise surveys suggest that managers are also concerned about corruption, unreliability of electricity, tax rates, and access to finance. A central policy recommendation is to focus regulatory and administrative reforms on areas where Serbia clearly lags most: construction permitting, paying taxes, registering property, enforcing contracts, inspections according to the EU standards, and promoting quality.

Introduction

78. The business environment affects both day-to-day transactions and incentives for investment. Through these channels it can either depress or enhance production and the exporting potential of a country’s enterprises. Reducing regulatory costs and market barriers can boost long-term growth. Relatively easy entry into and exit from the market facilitates reallocation of productive resources as inefficient firms are replaced by more dynamic firms better able to compete in regional and global markets. For Serbia to become an attractive destination for FDI in tradable sectors, the business environment will have to be improved fast enough to catch up with or leapfrog alternative destinations. The private sector responds far better when it is confident that the state will not reverse or supersede previous regulatory decisions by changes in policies or legislation. The more uncertain the legal and administrative environment,
the more likely it is that aggressive rent-seeking and short-term profit-taking will replace investments that bring lasting productivity increases (FIAS, 2009).

79. **Successful reforms are not about just overcoming immediate regulatory barriers or cutting administrative burdens but also about creating a National Quality Infrastructure.** A successful exporter needs supporting institutions that set internationally competitive standards; laboratories that can carry out the requisite measurements and tests and issue certificates of compliance; institutions that can conduct competent and rapid inspections; and an institution that can accredit all the other institutions. The whole complex of institutions that assure that a country’s products are of high-quality is referred to as National Quality Infrastructure (NQI). Once a country begins to export more than just commodities, its NQI becomes critical to establishing its reputation as a high-quality, efficient producer of complex products.

80. **The work of inspections and market surveillance institutions could be significantly improved.** Procedures related to the work of different inspections at the national and subnational level are not fully in line with EU requirements. Presently there are more than 30 inspections with the mandate to control the work of Serbian businesses and their requirements, and rules are often not harmonized. In addition, there is no cabinet level body that could oversee the work and performance of all these inspections. Finally, the market surveillance structure that exists in Serbia does not comply fully with EC legislation.

81. **Serbia has already come a long way since it embarked on structural reform.** In the seven years since the last Investment Climate Assessment (ICA), the process of starting and closing a business has speeded up, getting credit is easier, competition legislation has been harmonized with that of the EU, it is now easier to lay off workers, the time needed to register a property has been cut by 40 percent and the property transfer tax reduced, there have been improvements in the court system, contract enforcement has been firmed up, and movement across borders is faster. These and other improvements are confirmed by surveys of the perceptions of managers.

82. **However, in a world where most countries are trying to improve their business environment, speed of reform must be that much faster.** Figure 3.1 shows that while doing business in Serbia has become easier in the past five years, most of the neighboring countries improved even faster. Serbia must keep improving just to keep its place.
83. **Comparison of components of the “ease of doing business” (EDB) indicator leads to two conclusions.** First, since Serbia’s EDB ranking is only a little worse than its GDP per capita ranking, Serbia is roughly where it should be in terms of EDB. Only Bulgaria and Slovakia are doing noticeably better than their per capita GDP rankings would lead one to expect. Second, despite recent improvements, Serbia’s ranking dealing with construction permits (access to land), paying taxes, registering property, and enforcing contracts needs improvement (Table 3.1).

Table 3.1: Serbia and Comparator Countries on Components of Ease of Doing Business

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Serbia</th>
<th>Bulgaria</th>
<th>Czech Republic</th>
<th>Croatia</th>
<th>Hungary</th>
<th>Slovak Republic</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ease of Doing Business</strong></td>
<td>89</td>
<td>51</td>
<td>63</td>
<td>84</td>
<td>46</td>
<td>41</td>
</tr>
<tr>
<td><strong>Starting a business</strong></td>
<td>83</td>
<td>43</td>
<td>130</td>
<td>56</td>
<td>35</td>
<td>68</td>
</tr>
<tr>
<td><strong>Dealing with construction permits</strong></td>
<td>176</td>
<td>119</td>
<td>76</td>
<td>132</td>
<td>86</td>
<td>56</td>
</tr>
<tr>
<td><strong>Registering property</strong></td>
<td>100</td>
<td>62</td>
<td>47</td>
<td>110</td>
<td>41</td>
<td>9</td>
</tr>
<tr>
<td><strong>Getting credit</strong></td>
<td>15</td>
<td>6</td>
<td>46</td>
<td>65</td>
<td>32</td>
<td>15</td>
</tr>
<tr>
<td><strong>Protecting investors</strong></td>
<td>74</td>
<td>44</td>
<td>93</td>
<td>132</td>
<td>120</td>
<td>109</td>
</tr>
<tr>
<td><strong>Paying taxes</strong></td>
<td>138</td>
<td>85</td>
<td>128</td>
<td>42</td>
<td>109</td>
<td>122</td>
</tr>
<tr>
<td><strong>Trading across borders</strong></td>
<td>74</td>
<td>108</td>
<td>62</td>
<td>98</td>
<td>73</td>
<td>102</td>
</tr>
<tr>
<td><strong>Enforcing contracts</strong></td>
<td>94</td>
<td>87</td>
<td>78</td>
<td>47</td>
<td>22</td>
<td>71</td>
</tr>
<tr>
<td><strong>Closing a business</strong></td>
<td>86</td>
<td>83</td>
<td>32</td>
<td>89</td>
<td>62</td>
<td>33</td>
</tr>
<tr>
<td><strong>GDP per capita ranking</strong></td>
<td>82</td>
<td>74</td>
<td>38</td>
<td>44</td>
<td>45</td>
<td>41</td>
</tr>
</tbody>
</table>

Sources: Doing Business 2011; IMF.  
Note: Doing Business 2010 ranks 183 countries.

84. **Other evidence suggests additional problems that need attention.**  
The Global Competitiveness Report 2010-11 suggests that there are serious problems in the area of transportation, both in terms of physical infrastructure
and logistics. The EC Progress Report underlines the shortage of skilled workers. Serbia performs poorly in staff training, local availability of research and training services, quality of management schools and overall business sophistication. Finally, while only 20 percent of the managers in the BEEPS 2009 thought that power was a binding constraint, perceptions about the availability and quality of electricity have worsened the most (of all perceived constraints) between BEEPS 2005 and 2009.

National Quality Infrastructure

85. **Serbia has substantially improved its NQI.** The 2010 EC Progress Report states that Serbia is already relatively well integrated in terms of international measurement (metrology) and is making progress in harmonizing standards. However, harmonization has been slow and the metrology legislation is incomplete. Moreover, the Serbian accreditation system is not recognized abroad (Table 3.2).

Table 3.2: Membership in Regional and International NQI Organizations

<table>
<thead>
<tr>
<th>Standards</th>
<th>Accreditation</th>
<th>Metrology</th>
</tr>
</thead>
<tbody>
<tr>
<td>ISO</td>
<td>CEN &amp; CENELEC</td>
<td>IAF-MLA</td>
</tr>
<tr>
<td>Serbia</td>
<td>yes affiliate</td>
<td>no</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Croatia</td>
<td>yes affiliate</td>
<td>no</td>
</tr>
<tr>
<td>Romania</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Turkey</td>
<td>yes affiliate</td>
<td>yes</td>
</tr>
<tr>
<td>UK</td>
<td>yes</td>
<td>yes</td>
</tr>
</tbody>
</table>

Note: ISO - International Organization for Standardization; CEN - European Committee for Standardization; CENELEC - European Committee for Electrotechnical Standardization; IAF-MLA - The International Accreditation Forum - Multilateral Recognition Arrangements; ILAC-MRA - International Laboratory Accreditation Cooperation - Mutual Recognition Arrangement; EA-MLA - European Co-operation for Accreditation Multi-lateral Agreement; BIPM - International Bureau of Weights and Measures; CIPM-MRA - Comité International des Poids et Mesures Mutual Recognition Agreement; EURAMET - European Association of National Metrology Institutes; WELMEC - European Cooperation in Legal Metrology.

Policy Recommendations

**Ease of Doing Business**

1. Redesign the entire process for securing building permits, including getting approvals from public utilities. This can significantly reduce the cost of doing business and shorten the time required to obtain approvals.

2. Map and prepare an inventory of all administrative procedures at the national level that affect businesses. Calculate the full cost to business and propose detailed recommendations to streamline these procedures. Monitor the process and keep the public informed.
3. Incorporate the full inventory of all national procedures into Serbia’s E-Register of procedures and create a mechanism to track changes when procedures are changed.

4. Continue supporting simplification of subnational regulation and link it, through the Better Regulation Unit, to the national level to ensure coordination.

National Quality Infrastructure

1. **Standards:** Ensure that all standards critical to industrial competitiveness are fully translated into Serbian. The Institute for Standardization of Serbia (ISS) budget should be supplemented to ensure the Institute’s full participation in regional and international standardization activities.

2. **Metrology:** Consider the suitability of alternative metrology models. The National Metrology Institute and the Directorate of Measures and Precious Metals are embedded in the government. In many EU15 and OECD countries, however, NMIs are semi-independent bureaus that can respond directly to private sector needs. In any case the Directorate of Measures needs to be adequately funded.

3. **Testing and certification:** Build up laboratories (testing, pathology, environmental) and the organizations that certify products and systems organizations to ensure that agreed standards are being met.

4. **Inspections:** Reform inspection procedures to align them with EU requirements and country specific rules and practices. The approach would be to: (i) consolidate the more than 30 inspections (excluding fiscal) into 12–15 inspectorates within ministries; (ii) prepare a procedural law to govern all matters related to inspections; and (iii) create a small, Cabinet-level General Inspectorate to govern inspections in Serbia and maintain internal control.

5. **Accreditation:** Build the capacity of the national accreditation body to attest that an organization or an individual is competent to offer specific conformity assessment services, such as testing, inspection, and certification. The government should make accreditation a precondition for conformity assessment bodies to operate in the field of technical regulations. At present, many bodies are not accredited.

6. **Market surveillance:** Set up a market surveillance structure that fully complies with EC legislation and design a mechanism for effective coordination among market surveillance authorities.
Chapter 7: Skills

Introduction

86. **Skills mismatch is a serious issue for Serbia: the skills the educational system is producing are often not the ones in most demand in the economy.** The result is simultaneously high unemployment (especially among younger workers) and specific skills shortages. The rapidly aging population is aggravating the problem because the system is losing skills faster than it is building them. Serbia’s educational system has some strengths, including high functional literacy at the secondary school level, but there are problems of quality at all levels. Resolving the skills problem will require comprehensive reforms across the board—in early childhood education, general secondary and TVET, higher education, adult education and training, and Active Labor Market Policies. Only a comprehensive overhaul of the entire system will make it responsive to the demands of the modern economy and capable of equipping people with skills that make them competitive in the wider European market.

Labor Market Performance

87. **The labor market in Serbia is changing dramatically.** While the country has undertaken substantial economic reforms toward market liberalization and its economic growth has been considerable, growth in the economy has not been accompanied by growth in employment. By 2010, only 47.1 percent of the working age population (15–64) was working, 11.7 percent were unemployed (equivalent to a 19.9 percent unemployment rate), and 41.1 percent were inactive. Employment rates are particularly low among those with secondary education or less, among women, among youth and older cohorts, and among Roma.

88. **Serbia is experiencing substantial labor market challenges.** Among those aged 20–64 the employment rates of 59 percent for men and 43 percent for women are very low, both in absolute terms and compared with the EU as a whole and with neighboring new EU member states (Figure 3.2).

89. **For every age cohort from 20 through 64 for both males and females, closing the employment gap between Serbia and the EU27 by 2020 will require creation of 57,000 new jobs a year—and reaching the EU2020 target of 75 percent rate will require about 87,000 new jobs a year.** (For detailed analysis of Serbia’s employment and skills situation, see
Illustrative scenarios presented in Chapter 2 suggest that even in the high case, Serbia cannot close the employment gaps by 2020. Depending on outcomes, however, it can hope to be back to relatively full employment as early as 2025.

Figure 3.2: Serbia and the EU 2020 Employment Target (75 percent of 20–64-year-olds)

Source: Eurostat 2010 and 2010 Serbia Labor Force Survey (Author’s calculations).

Serbian firms see a disconnect between the type and skills level of students graduating from Serbian schools and labor market needs in certain occupations. For example, in a 2009 ILO survey, manufacturing firms were least likely to report that “all skills are adequate” with regards to skilled trades and process machinery employees, with technical and soft skills deemed to be most lacking. Only 36.5 percent of manufacturing companies considered the skills of their skilled trades workforce to be “adequate” and 49.3 percent found the machinery processing workforce to be “adequate” (Figure 3.3).
91. **Technology and team work skills were the most valued by employers covered by this survey.** Figure 3.3 breaks down specific competences for these two areas that firms considered weak. It shows “use of materials, technology, tools and equipment” to be the biggest constraint; for the skilled trades (40 percent) and the process and machinery workforce (55 percent) in firms experiencing growth. The next most common competences lacking were flexibility and team work.

### Education and Training System Performance

#### Formal Educational Attainment

92. **Educational attainment levels in Serbia are considerably lower than in the EU27 countries.** Only about half the Serbian population (49 percent of men and 54 percent of women) completed at least upper secondary, well below the 2008 EU27 average of 71 percent for both. Serbia also has a fairly high proportion of the people with very little education. Among men aged 25–64, about 21 percent have at most primary education, 30 percent lower secondary (1–3 years), 33 percent upper secondary (4–5 years), and 16 percent post-secondary education. Among women there is more variation; about 30 percent of the working age population has at most primary education, 17 percent lower secondary, 35 percent upper secondary, and 19 percent post-secondary education.

#### Early Childhood Education
93. Pre-school education is internationally recognized as one of the most critical steps in ensuring skill development at all subsequent ages (World Bank 2010b). However, according to 2008 data, the net pre-school enrolment rate of 52 percent among 3–6 year-olds indicates that Serbia lags behind some of its neighbors and all EU new member states. More positively, in school year 2006/07 Serbia introduced the mandatory preparatory pre-school program, a so-called zero grade. In 2009, this program was extended from 6 to 9 months and caused a significant increase in pre-school attendance for children aged 5.5 to 6.5.

General Secondary and TVET Education

94. Due to the demographic decline, the number of students entering secondary schools is falling. Between school years 2005/06 and 2009/10 the number of students entering secondary school fell by 5 percent, for a total of almost 4,000 students. This trend will continue, creating pressure to urgently address issues linked to the size of the school network.

95. Serbia has far more students attending vocational schools at the secondary level than other countries. More than three quarters (76 percent) of its secondary students are in vocational tracks. Moreover, between 2001 and 2007 Serbia was the only country in the region with a rising share of secondary technical vocation and educational training TVET students.

96. Over the past 10 years, secondary school reform efforts were mostly directed at vocational schools. The practice of separating reform of TVET and general secondary schools is preventing more strategic and comprehensive reform.

97. The current system of secondary education is characterized by early tracking, which forces 15-year-olds to make decisions about their future careers very early in life. The system is also restricts horizontal mobility; no mechanisms are in place to allow movement between different education tracks or between general and vocational programs. Schooling is organized in a traditional manner, with heavy emphasis on theoretical knowledge and few opportunities for students to gain practical competences.

98. The quality of Serbian education as measured by performance on international PISA student testing is on the rise but is still below the OECD average. Over the three cycles of Serbia’s participation in PISA, its 15-year-olds showed a modest level of achievements in reading, mathematical, and scientific literacy. As well, functional illiteracy is very high.

Higher Education
99. **The majority of students who complete secondary education subsequently enroll in institutions of higher education.** An estimated 79 percent secondary graduates continue education in the academic year when they complete secondary schooling.

100. **High gross enrolment rates in higher education contrast starkly with the much lower completion rates** among 25–34-year-olds, 14 percent for men and 25 percent for women. This suggests that many, possibly as many as half, of those enrolled do not graduate. In addition, only a quarter of students who do graduate do so according to the timeline set by their programs.

101. **Inefficiency of spending on higher education is a major problem.** This is partly a result of the long legacy of strong autonomous university faculties that leads to costly duplication in teaching (with each faculty organizing its own courses in subjects outside its specialization), administration, and services (World Bank 2004). There are few accountability mechanisms, and curricula are often outdated, with teaching methodologies and single-discipline programs that are highly theoretical and not well linked to labor market realities.

**Adult Education and Training**

102. **Serbia has an insufficient system for adult education and training; its function is mostly remedial, and is not well adapted to labor market needs.** Adult education covers all programs designed for people 18 and older that are outside the formal education system. However, in Serbia, the adult education provided is limited and of low quality. There is no system for accrediting providers of adult education although there is a kind of certification process. Adult education is still seen only as compensatory, providing opportunities for the illiterate to obtain primary school and TVET certificates through “second chance” programs. A system for recognizing non-formal and informal learning has not yet been established and much of the adult education still reproduces curricula taught to children in primary schools.

103. **The proportion of Serbian adults attending formal training courses of any type is very low.** According to the October 2010 LFS, among all employed people aged 25–64, only 1.2 percent (about 26,000 people) reported having attended a “regular system” training course (primary, secondary, or tertiary) in the previous four weeks and 2.0 percent (about 42,000) attended a non-regular training course. Among those unemployed or inactive, 4.5 percent (about 82,000) attended regular training and 0.6 percent (about 10,000) attended non-regular training. Virtually all regular system training happens in the 25–34-year-old cohort.
Active Labor Market Programs

104. **Serbia spends only a fraction of what other European countries spend on active labor market policies** In 2010, Serbia spent about 0.7 percent of GDP on unemployment benefits and only 0.1 percent of GDP on active labor market programs (ALMPs) The former is about the same as the OECD average, but the latter as a proportion of GDP is only one quarter of the OECD average of 0.4 percent. To match that average, Serbia would need to invest about €100 million a year (Figure 3.4).

105. **The number of people reached by ALMPs is far below the number needed to reduce the gap in employment between the EU and Serbia.** Reaching the EU2020 target of 75 percent employment among those 20–64 will require about 87,000 new jobs a year. However, in 2010, just 17,175 youth participated in First Chance program and 4,697 people participated in direct training. Many more people were reached by career guidance/counseling through job fairs, but given the marginal spending in this category, this is unlikely to have substantially raised employment. If Serbia were spending the OECD average of 0.4 percent on ALMP training programs, it could train another 177,000 people annually in its current programs, or train another 105,000 people annually in more expensive First Chance-type programs.

![Figure 3.4: Comparison of Public Spending on Active Labor Market Policies, 2008](image)

Source: OECD Stats. 2011 (data for 2008); Serbia data for 2010 (NES, 2010)

Policy Recommendations

**Given the crisis in employment, recommendations in the area of Active Labor Market Policies are probably most pressing, but there is a logic to presenting recommendations in chronological sequence starting with early childhood.** Ultimately, it is the cumulation of effects, as a person
progresses through the various parts of the education and employments system, that leads to overall poor outcomes.

1. **Early Childhood Education: get children off to the right start.** Continue to expand provision of early childhood education (ECE), lengthening the time children spend in ECE and ensuring that vulnerable groups like Roma participate fully. Handicaps acquired early in life are difficult if not impossible to remedy later; effective ECE programs emphasizing nutrition, stimulation, and basic cognitive skills can have a very high payoff in terms of primary school performance and secondary school completion, especially among the poorest and most vulnerable groups.

2. **General Secondary and TVET: keep students in school longer, learning more relevant skills.** Serbia should continue working to reduce drop-out rates and increase school completion by creating compensatory/bridging courses and programs and by offering remedial education to students at risk. Government should try to make curricula more relevant to the labor market by strengthening venues for collaboration between the education sector and employers. In addition reform of curricula should be done in an integrated and coordinated way, emphasizing partnership between different education councils.

3. **Higher education: ensure student accountability in higher education and build field-specific knowledge.** There should be additional efforts aimed at ensuring that more students finish as scheduled by increasing student accountability for results. In addition, government should explore options how to offer baccalaureate students a university education that moves away from often highly theoretical mono-disciplinary programs to a broader curriculum that emphasizes such competences as critical thinking, creativity, initiative, and problem-solving.

4. **Adult Education and Training: scale up adult training, build partnerships, and ensure labor market relevance.** The government could consider how to increase the amounts spent on adult education and training in order to increase the coverage and revise the scope of training by focusing on the skills that employers are demanding. Also, more middle-aged and older workers should be targeted for training, both those unemployed and those still employed but at risk of leaving the labor market.

5. **Active Labor Market Policies: evaluate both current and planned activities in order to improve its effects.** Budgets for active labor market programs need to be scaled up to bring them closer to the European levels. Also, government can consider adopting a one-stop-shop approach for services providers, building on the experiences of other employment offices in Europe, which are offering in one place a mix of job search assistance, training, employment subsidies, and sanctions.
Chapter 8:
Energy

Introduction

106. Energy, especially electricity, is perhaps the most acute constraint for sustained expansion of Serbia’s economy and exports, especially once the economy starts growing faster. Indeed, Serbia is facing a looming power crisis; already, generating capacity is not adequate to meet peak demand, and projections of consumption and new capacity show the gap increasing after 2015. Serbia is a high energy consumer, and the level of energy intensity (EI) in Serbia is substantially higher than in other Balkan countries and in the EU. High EI reflects the effect of policies that directly and indirectly promoted energy consumption through subsidized prices and tolerance of non-payment.

107. This suggests that any viable strategy for reform must include measures to rationalize energy demand, such as changes in tariffs toward cost recovery, accompanied by appropriate social protection mechanisms, and encouraging payments discipline. The sector also needs to address irrational costs, to substantially improve institutions and regulation, reduce commercial losses, build new capacity, and rehabilitate transmission and distribution. This cannot be done by the public sector alone. In fact, the private sector, domestic and foreign, will have to take on the bulk of the burden for transforming the system and increasing its delivery efficiency to meet growing demand. For this to happen, major reforms are necessary to open up the system to private sector participation and well-designed public-private partnerships (PPPs.)

The Looming Crisis

108. As growth resumes Serbia will soon encounter electric power shortages. Already in 2008 the BEEPS showed that 33 percent of firms considered electricity a problem, more than double the number in 2005 and the sharpest increase for any of the obstacles registered in the survey. In 2008 generating capacity was not able to meet peak demand and Serbia was relying on imports to balance its demand and avoid load shedding. Although the then imminent power crisis has been pushed back by the drop in demand caused by the global economic crisis, once the recovery takes hold, shortages will undoubtedly resume (Figure 3.5).
The electricity system is old, unreliable, and inefficient. More than half (53 percent) of the generating plants are more than 30 years old and some will have to be retired over time despite ambitious rehabilitation programs. With less than 25 percent of the transmission lines and substations in good condition, transmission capacity constraints make it difficult to accommodate new generation capacity (especially for renewables) and increased regional trade. Rising distribution losses now stand at some 15.8 percent of gross electricity consumption—compared to 5.6 percent in the Czech Republic and 5.2 percent in Slovakia. The losses are due to a deteriorated distribution network, malfunctioning electricity meters, and theft.

The Energy Intensity (EI) of the system is double that in neighboring countries, partly because of the age and inefficiency of the system, but also because the price of electricity is among the lowest in the region (Figure 3.6). It is estimated that prices would have to rise by 40 – 80 percent to fully
recover costs and long-term investment requirements. The low price means that demand for electricity is considerably higher than it would otherwise be and therefore creates pressure for investing in expensive new capacity beyond what would be necessary with appropriate tariffs. These heavily subsidized tariffs have allowed energy-intensive users to reach EI levels that are completely out of line with world standards (Figure 3.7). Energy technologies that are much more efficient than those currently used in Serbia are commercially available, but there is little incentive to install them when tariffs are so low.

Figure 3.6: Electricity Prices by Main Consumption Category, 2009 (Weighted average)

![Bar chart showing electricity prices by main consumption category for various countries](chart)

Source: Energy Regulators Regional Association database.

111. Using commercially available energy-saving technologies in Serbia’s main exporting industries would offer potential for large energy savings. Serbia’s key exporting industries (non-ferrous metals, basic metals and non-metallic minerals) are by far the most energy intensive. Figure 3.7
indicates that these industries use far more energy to produce one dollar of economic output than the same industries in other countries. Realizing such energy efficiency potential would be vital for maintaining their competitiveness. If this is not done, increasing energy tariffs by 40 percent could decrease exports in these key industries by as much as 20 percent.

112. **Efforts to scale up the energy efficiency of Serbia’s exporting sector seem to have been sparse and relatively modest considering the challenge.** The government has made energy efficiency a priority and has succeeded in setting up legislative and institutional frameworks to promote it, but there are still several barriers to concrete action. The 2004 Energy Efficiency Law and its secondary regulation provide the legal basis and measures to promote and support energy efficiency. Also, the Energy Efficiency Agency of the Republic of Serbia (SEEA) has been set up to provide institutional support. However, there are a number of barriers preventing cost-effective investments from materializing are: (i) lack of institutional capacity to educate the public and promote energy efficiency; (ii) lack of supporting laws and regulations; (iii) lack of skilled staff; (iv) lack of financing designed specifically for energy efficiency programs; and (v) lack of credible and accurate data.

**Figure 3.7: Energy Intensity by Sector and Country**

Source: World Bank estimates based on data from the Global Trade Analysis Project (GTAP7).

113. **Power generation and transmission have been unbundled from the state owned power company EPS, but further reforms are needed to unlock Serbia’s potential to participate in the regional power market.** The electricity market was restructured in 2005 in line with EU directives. If Serbia
is to increase domestic competition in its power market and participate in the regional electricity market, it must further separate competitive and monopoly activities (such as retail activities and distribution networks). In addition, necessary regulation, including establishing transit capacity pricing methods and congestion management rules, has yet to be coordinated at the regional level. Doing so would speed Serbia’s participation in a competitive wholesale regional electricity market and its ability to attract badly needed investments in generation and distribution.

114. Equally important is to prepare electricity utilities for competitive pressures in generation and retail that are emerging in South East Europe. Thus, EPS needs to follow up on its strategy and action plan to restructure for greater operational efficiency, which would facilitate the needed investments. The reform program, however, will need to be carefully designed and managed considering the social impact that some restructuring measures could have.

115. Serbia’s high resource endowments in primary energy suggest it will be able to ensure the power supplies necessary to sustain projected growth in demand. To do so, however, it will be necessary to mobilize substantial investments in the short to medium term. The current capacity of the system is about 7,000 MW, but once allowance is made for reserves in case of breakdowns, the system has been operating at full capacity since 2007 (Figure 3.5). In the most optimistic scenario, the demand-supply balance will be precarious until 2015. After that, as some older generation capacity is decommissioned, the shortfall in supply will have to be met by imports. In the transmission system, additional and upgraded links to neighboring countries are necessary required to fully integrate the system into the regional and European transmission network. Further transmission upgrades will be required to accommodate renewables (especially wind power in the north). The distribution network needs a modernization plan, including better metering to improve collection; rehabilitation and modernization of its medium voltage system, and financial and institutional arrangements for the substations system (KV 110) to be transferred from EMS to EPS.

116. However, the investment needs estimated for the power sector are beyond the financial reach of the public sector. EPS estimates that to keep ahead of demand in this decade would require investment of some €16 billion (see Chapter on Energy in Volume 2), of which the public sector could provide no more than €4 billion. The private sector will have to bridge the investment gap. According to government investment plans, the private sector participation in the sector would need to increase from almost nothing today to €12 billion by 2020.

Policy Recommendations
1. **Make the power sector more financially viable by increasing tariffs to the full cost recovery level and address high cost of production.** The increase in electricity prices will need to be sizable (between 40 percent and 80 percent). Transferring tariff-setting authority from the government to the independent regulator will help make regulation credible and predictable, thus mitigating risks for investors, whether public or private. Arrangements will be necessary to protect the poor from the increase.

2. **Tighten payment discipline to reduce losses and bring the sector to commercial viability;** install metering devices and restructure the distribution system. In some ECA countries\(^\text{10}\), overcoming the nonpayment problem involved (a) amending laws to enable service providers to recover what was due from clients speedily and deny services to those who did not pay up; (b) making theft of services a criminal offense; (c) ensuring that government departments and agencies have adequate budget to pay their service bills and subjecting them to the discipline of disconnection for nonpayment.

3. **Improve energy efficiency.** The government needs to design a strategy that would create the enabling environment, with rules and standards for the participation of private capital and technical capacity to prioritize and significantly increase investments in energy efficiency.

4. **Reinvigorate reform of the entire sector in line with the EU’s *acquis communautaire*.** That implies deepening the current unbundling, continuing to open the domestic market, and adopting regulatory measures and incentives to support creation of a competitive regional electric power market.

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\(^{10}\) In the main report there is an overview of different initiatives in Kazakhstan and Georgia.
117. **Secure land rights and effective land administration are areas in which Serbia is falling behind other countries in the region.** The consequence is that foreign investors are turning away and local investors face avoidable difficulties. Similarly, agricultural land in Serbia is highly fragmented by EU standards, making production more expensive and discouraging investment. As a result, economic growth is hindered, with negative consequences, both short- and long-term, for the economy and for society. Further, because of poor land administration the government has forgone large amounts of revenue, at least some of which could have been used to promote investment through, for example, upgrading infrastructure.

118. **Nevertheless, there are positive elements that can be used to help resolve the land-related challenges facing the country and the economy.** The market for buying, selling, and leasing real estate is relatively efficient, the mortgage market is developing, government officials are generally well educated and experienced, recently there have been positive legislative reforms, and the real estate cadastre (REC) is almost fully established throughout the country.

119. **The government now needs to address three problem areas:**

- *making property rights more secure*: Implementing the restitution and compensation program and addressing problems with urban land conversion;
- *improving land management*: streamlining the permitting process, regularizing illegal buildings and settlements, and overcoming land fragmentation; and
- *strengthening institutions*: building up state land management capacity and systems, training officials, developing valuation skills and the valuation system, and making governance in the land sector more transparent.

**Property Rights**

120. **In interviews in preparation for this report, the private sector representatives expressed as a major concern the insecurity of private**

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11 Interviews were conducted in Belgrade in March and April 2011 with representatives of the private sector associated with the property and banking sector, nongovernment organizations, municipalities, and central government ministries and agencies.
property rights. The unsettled nature of the restitution issue makes investors, particularly foreign investors, apprehensive about property rights and thus unwilling to invest. The process of converting use rights to full ownership rights, too, has been handled in such a way that it has undermined rather than promoted the security of property rights.

Restitution

121. The Law on Restitution and Compensation passed in September of 2011 should alleviate some of the current uncertainty. It specifies certain categories of properties to be restored to their former owners and other categories that are not to be restored. However, it must be implemented promptly. Experiences in neighboring countries have shown how slow the restitution and compensation process can be and the problems that then arise. Security of property rights can be threatened if claims for a property linger for long periods.

122. The deadlines in the law are ambitious, given that about 100,000 claims are expected. Based on experience elsewhere, the six-month deadline for making decisions will be difficult to meet unless substantial resources are made available to the proposed restitution agency. Resources will be needed for: (i) staff with appropriate qualifications and training; (ii) information and access to real estate records; (iii) public relations services; (iv) technology support including for valuation services; and (v) financial management.

Conversion of Use Rights to Full Ownership

123. The second area in which recent government action has threatened the security of private property rights is in the conversion of use rights to full ownership. Under the 2009 Law on Spatial Planning and Construction, people and legal entities holding use rights to properties are entitled to convert them to full ownership. This supports the security of property rights because it makes the rights more robust. However, implementation has been slow: the government failed to issue necessary regulations promptly, failed to train officials to process applications efficiently, and failed to promptly introduce anticipated changes to the law.

124. The consequences have been worrisome. First, there is confusion about the status of current property rights; while things remain unsettled, there is concern that use rights have been made less secure. Foreigners considering investing in land in Serbia could have deferred doing so while matters remained uncertain, and thus growth opportunities were lost. Second, because applications for conversion of use rights to ownership rights were processed slowly, those seeking construction permits could not provide the municipality with evidence of ownership, so that construction was delayed, or possibly cancelled – and more growth opportunities were lost.
Land Management

125. **Government revenue is lost when land use is inefficiently managed and there is poor planning and permitting, illegal building and settlements, and land fragmentation.** They also make investment in the sector far less attractive.

**Issuance of Construction Permits**

126. **The process of obtaining a construction permit is a major barrier to anyone who wants to construct a new building.** Building permits are regulated by the 2009 Law on Spatial Planning and Construction. While reasonably drafted, there have been serious problems in applying it, particularly with respect to the issuance of permits. Though the law was enacted in September 2009, many of the necessary by-laws or regulations did not exist until recently. Further, the municipal staff charged with implementing the law are said to have had no training and did not know how to implement the permit provisions. Consequently, for some time no permits were issued and new construction stalled. Permit issuance resumed only in mid-2010, after by-laws were issued in April.

127. **Besides the complexity, there are cost impediments to carrying out construction, at least formally, in Serbia.** In *Doing Business 2011* Serbia ranks near the bottom (at 176 out of 183) in terms of cost of construction permits (Table 3.3).

<table>
<thead>
<tr>
<th>Country</th>
<th>Rank</th>
<th>Procedures (Number)</th>
<th>Time (Days)</th>
<th>Cost (percent of income per capita)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Serbia</td>
<td>176</td>
<td>20</td>
<td>279</td>
<td>1821.4</td>
</tr>
<tr>
<td>Hungary</td>
<td>86</td>
<td>31</td>
<td>189</td>
<td>9.8</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>76</td>
<td>36</td>
<td>150</td>
<td>16.4</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>56</td>
<td>13</td>
<td>287</td>
<td>12.7</td>
</tr>
<tr>
<td>Poland</td>
<td>164</td>
<td>32</td>
<td>311</td>
<td>121.8</td>
</tr>
</tbody>
</table>

*Source: Doing Business 2011.*

**Illegal Buildings**

128. **Illegal building is, to a significant extent, a result of the slow and expensive construction permit process.** This is generally not an issue for large businesses for which the cost is small relative to the size of their investment. However, it is a concern for many individual citizens and small or medium-sized investors.
129. **Illegal building is widespread and negative effects are numerous.** The number of properties with some aspect of illegality is thought to exceed 800,000. Illegal settlements thus represent a major proportion of Serbia’s building sector. The negative consequences to the illegal buildings phenomenon are numerous, among them problems related to public health and safety, fire safety, water and sewerage supply, power and other utility supply, access to properties, urban planning and construction, and materials standards.

130. **Another consequence is lost income to government.** This comes in two forms: lost annual property tax payments for local governments and lost contributions from the infrastructure fee required to obtain a construction permit. Many municipalities struggle to provide adequate services and could use the forgone income both to meet their basic obligations and provide infrastructure that would facilitate investment. Assuming that there are about 800,000 illegal buildings and annual property tax of €100 per property, local municipalities may be losing up to €80 million annually in taxes. Further, assuming an infrastructure fee of €2,000 per property, some €1.6 billion has been lost to local government in the last two decades.

**Land Fragmentation**

131. **The fragmentation of agricultural land is a major problem for Serbia.** Compared to the EU countries, Serbia’s agricultural holdings are fragmented and thus less efficient. Experience from countries like Sweden, the Netherlands and Slovenia suggests that investing in land consolidation, although costly, can have high returns (for details see Volume 2). The benefits of such a program include increased production and employment, higher tax revenues, better rural conditions, increased market values for consolidated properties, improved ownership conditions, better infrastructure, and accurate property registers and cadastral maps.

**Institutions**

132. **Inefficiencies in Serbian institutions, such as poor management of state-owned properties, are limiting government revenue and holding back growth.** Forgone revenue from property taxes on legal as well as illegal settlements, poor use of state property assets, and the opportunity cost of reduced foreign investment limit the country’s growth potential.

133. **Serbia collects much less in property taxes than it should.** One reason is that records on buildings are often incomplete and inaccurate. Tax valuation of properties can also be problematic because properties can be valued on the wrong basis, using out-of-date data, or without proper understanding of valuation principles.
Lack of valuation skills in the public sector is of particular concern to the private sector, because many of its obligations consist of payment of fees and charges based on the value of property. The Tax Authority database, which has evolved over years through sporadic one-off valuations based on actual sales documents, is not available to the private sector.

Policy Recommendations

Property Rights

- Ensure that property rights are secure and transparent: Bring in confidence in the restitution process. For that reason, the proposed restitution agency needs to have enough resources to finalize claims within a reasonable time.

- Assign a dedicated, trained team whose sole responsibility is to deal with applications for conversion of urban land from use rights to ownership rights. Additional staff may be needed. Valuation could be particularly important. The government should also create a campaign to make the public aware of the policy position.

Land Management

- Create a plan to build municipal capacity to deal with the permits issue. Also assign a monitoring and evaluation team to observe implementation of the law.

- Simplify the procedures for obtaining construction permits with the objective of encouraging investment.

- Create a building cadastre in which every building, including state-owned, is recorded and its status (legal or illegal) identified.

- Build upon the pilot programs to formulate a national land program for consolidating fragmented acreage of agriculture land.

Institutions

- **Create up-to-date inventories of state properties**, national and municipal, and introduce a system for keeping the inventory current.

- To improve transparency, **report results of public tenders and auctions** of state land and buildings that result in transactions: numbers, prices, buyers.

- To increase understanding of property values, **make the Tax Administration valuation database available** to the public, or, at least, to government officials responsible for managing property.

- To improve capacity, **conduct training for local municipalities on good management of public assets**, particularly how to assess which properties are
not needed for operations and can therefore be sold or leased to the private sector.

- **Create a valuation authority**, either within or independent of the Tax Administration, and properly train and resource its staff. The authority would be responsible for mass valuation.
Chapter 10:
Trade Facilitation

Introduction

135. Trade facilitation constitutes a wide range of activities that can lower trade transaction costs for firms. National frontiers impose complex procedural requirements on incoming and outgoing goods. Countries that ensure that these are met with minimum costs and delays are potentially more attractive to FDI as well as being considered attractive transit countries. That is why policymakers are increasingly concerned with logistics, which encompasses transportation, cargo consolidation, warehousing, border clearance, and payment systems.

136. Serbia performs relatively well on a number of measures of trade facilitation, but it is still weak in several areas important for exporters. The *Doing Business 2011* Trading Across Borders sub-index puts it 74th in the world, ahead of neighboring countries like Bulgaria and Croatia. In the 2010 Logistics Performance Index (a composite of measures related to customs, infrastructure, international shipments, logistics competence, tracking and tracing, and timeliness) Serbia ranks 83rd. But it is still relatively weak in such logistics subcomponents as customs, timeliness, and the rate of physical inspections—all of which are of particular importance to exporters and to transit traffic. That is why work for this report centered on facilitation audits of customs and logistics conducted specifically for this report. The recommendations are based on the findings of these audits.

Customs and Border Clearance

137. The Serbian Customs Administration had been making significant gains in productivity, but that has slowed. The cost effectiveness of customs, calculated in terms of total costs compared to revenue, moved from a ratio of 3.77 to 1.48 in 10 years—a nearly 155 percent improvement. During the same period staff productivity, based on average annual number of declarations processed by customs officers, improved by over 70 percent. The average consolidated duty ratio (collections compared to assessed values) increased by 80 percent. The 80 percent correlative increase in salary costs had a less than proportional effect on the economic cost per declaration, which only went up by 70 percent. After a spectacular start, gains in productivity started to stagnate in 2007, revealing that the considerable progress in previous years had reached its limits and would not be sustained without a qualitative leap.
138. **Although physical inspection rates have declined, they are still above EU levels.** Under the legacy system of all transition countries, until 2006 the culture of control by default led to nearly 100 percent examination of all imports. Routine inspections are cursory, risk management is minimal, and there is no focus on a specific type of fraud as a targeted control would provide. However, after 2006 when a more risk-based approach to inspection was adopted and there were fewer but better-organized controls, detections began to increase and clearance delays were reduced. This was also more cost-effective, reducing the marginal cost of compliance. It should be noted that the traditional EU benchmark of approximately 5 percent inspections may be too low in a country like Serbia, at least for the moment. Experience in Bosnia and Herzegovina suggests that the optimum rate of physical inspection, the one that yielded most detection, was close to 20 percent.

139. **The role of customs is not clearly defined.** While in most EU countries customs is considered to be responsible for ensuring that anything and anyone crossing the border complies with national law, the Serbian Customs Administration is still affected by the lingering pre-transition idea that it is essentially in charge of controlling goods for revenue-collecting purposes. This affects customs and border performance in several ways: 1) slow functional integration of customs and border police and 2) limited role of customs in the process of checking conformity with the phytosanitary and veterinary requirements.

140. **The new Customs Law might bring some improvements but there are some concerns as well.** First, it is difficult to operationalize the new law when most of the new concepts are alien. For example, the new law describes the risk management approach, but the risk management unit in headquarters is part of the enforcement directorate, thus reinforcing the notion of control by default. Second, some aspects of the new customs law will require significant changes to present operations. For instance, the liberal granting of warehouse licenses (there are several hundred in Belgrade alone) will have to be discontinued. Third, the law introduces new concepts that might not be well understood in the context of Serbia. An example is Approved Economic Operator (AEO) status, which is a recent international principle that most countries have not yet defined operationally.

141. **Enhancing customs performance will require a package of second-phase reforms.** The progress made reflected departmental commitment to modernization and the introduction of EU-compatible approaches and technologies. New concepts, such as the integration of border control or risk-based checks, have contributed to a sense of efficiency and responsibility toward users. To upgrade to EU standards, Serbia now needs a second phase of reform, which will require mainstreaming indicators and agreeing on performance benchmarks with private involvement. Border institutions—not just customs—need to be credible in terms of securing borders. Earlier reforms largely tended to deal with specific legacy problems, but they were

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12 The multiplicity of private warehouses raises a serious control problem for customs.
not applied in the context of how to operate in Western Europe. A new change-management approach is needed, based on a critical analysis of objectives and the means necessary to achieve them.

**Policy Recommendations**

1. **Rethink Integrated Border Management.** In order to reduce the time spent at border crossings by the goods forwarders, one option is the introduction of integrated border management. Integrated Border Management is a complex process that calls for close inter-agency integration and cooperation, compatible IT systems, and strong compliance and traceability. Some of this is already underway, at least in terms of legislation, but actually bringing the efficiency of border management to EU levels still lags.

2. **Give the Customs Administration a greater role in customs policy and develop proper HR policies.** To speed up the process of the timely updating of the legislation related to the work of the Customs Administration (CA), the CA could be given a larger policy role, including the establishment of a directorate for compliance that would cover risk management and policies related to valuation, origin, and tariff and post-clearance audit. The CA could also consider establishing a career path for customs officers like those in other European countries.

3. **Consider juxtaposed border facilities with the neighboring countries, probably starting with Croatia or Bosnia and Herzegovina.** Shared or juxtaposed facilities generate economies of scale because the two countries’ border stations are located on the same platform. This enhances cross-border cooperation, reduces waiting times and takes advantage of economies of scale.

4. **Finish developing a state-of-the-art inland customs clearance process.** Redeploy staff to real control functions. Redefine the electronic single window, moving away from lodging all documents (customs, transport, phytosanitary, etc.) at a single point. Rationalize warehousing principles and control.

5. **Containers management and inspection can be improved.** At present, when clearing customs, containers have to be taken off their trailers. In advanced countries large-size X-ray digital radiography is used to inspect full containers sitting on their trailer. Only suspicious cargo is opened. Serbia has neither the requisite inspection equipment, nor a system of risk profiling of cargo.

6. **Simplify procedures for trade in food products.** Reduce the number of cases where analysis is required; hours during which applications for phytosanitary certificates are accepted at border crossings should be extended, and cold storage priority for customs clearance should be enforced.

7. **Make product quality standards and the tariff system consistent with those for EU member states.** Harmonization with EU standards and tariff structure is essential to cut waiting times and expedite customs clearance. In this regard
Serbia should look to the Online Customs Tariff Database (TARIC) and should make more use of the binding tariff advice provisions of the EU Customs Code.

8. **Build an IT system that can support the entire Customs reform agenda.** For that the e-business plan should be developed together with a prioritized action plan.
Annex 1: KEY POLICY RECOMMENDATIONS

In the Short Term

Macroeconomic Environment and Structural Reforms
- Maintain fiscal policy in line with the fiscal rules
- Implement structural reforms to increase productivity, competitiveness, and exports.

Revealed Comparative Advantages

Trade Policy and Product Space
- Monitor the performance of key export sectors (€)
- Continue with adequate trade policy including the completion of the WTO application process. (€)
- Identify promising export clusters to define and regularly update export strategy. (€)

Industry
- Target high-value-added FDI through investment promotion programs. (€€)
- Promote public-private partnerships and investments in R&D. (€)

Agriculture
- Make the agriculture policy process more predictable by adopting and sticking to a sector strategy.
- Build an effective extension service that can change the behaviors of farmers. (€€)
- Continue with trade liberalization.
- First reallocate resources away from ineffective support measures (area payments, milk subsidies), then gradually increase the budget envelope until key reforms are adequately resourced. (€€)
- Streamline supply chains and promote investments where needed. (€€)
- Replace the DCR with EU compatible institution

Impediments to Export-Led Growth

Business Environment
- Improve the mechanisms for consulting with the private sector on proposed laws that affect business. (€)
- Prepare and incorporate the full inventory of business related national procedures into the E-Register and devise a mechanism to track changes. (€)
- Continue to support efforts to simplify and harmonize subnational regulation. (€)

National Quality Infrastructure
- Continue to develop NQI in terms of standards, metrology, testing and certification, inspections, accreditation, and market surveillance, to reach EU standards (€)
- Develop the capacity of the National Accreditation Body so that it can attest to the competence of all organizations or individuals involved in quality assurance. (€)
- Establish a market surveillance structure that
Skills
- Expand Active Labor Market Programs (ALMPs) that have already been successful. (£€)
- Secondary education: Reform curricula in both general and technical/vocational streams to give priority to field-specific knowledge and transferable skills (£)
- Higher education: Introduce measures to reduce the average length of studying (£)
- Adult Education: Scale it up and ensure labor market relevance (£)
- General: Ensure that all national education councils in Serbia work together in preparing a comprehensive National Qualification Framework. (£)
- Explore additional ALMPs and scale up those with positive impact evaluations. (£€£)
- Secondary education: Intensify efforts to reduce early school leaving (£)
- Higher education: Build field-specific knowledge and transferable skills (££)
- Adult Education: Build incentive schemes for sharing the costs of adult training. (£)
- General: Ensure regular funding for collection of data relating to the organization, administration, and results of the education system. (£)

Energy
- Make the power sector financially viable by increasing tariffs and cutting unjustifiable costs. (£)
- Improve payment discipline to reduce commercial losses. (£)
- Protect the poor from the adverse effects of price increase. (££)
- Implement the new Energy Law in line with EU practices. (£)
- Improve energy efficiency, particularly in exporting industries. (££)
- Establish a mechanism for setting relative prices between district heating, electricity, natural gas, and solid fuels. (£)

Land
- Assign and train a dedicated team at the national level to deal with conversion of land use into ownership rights. (£)
- Simplify procedures for issuing construction permits. (£)
- Ensure that the proposed restitution agency is properly resourced. (£)
- Create a valuation authority and properly train and resource staff. (£)
- Build municipal capacity to deal with construction permit issues. (£)
- Create a comprehensive building cadastre. (££)
- Building on pilot programs, prepare and implement a national agricultural land consolidation program. (£££)
- Build up institutions that manage state-owned properties. (£)

Trade Facilitation: Customs and Logistics
- Rethink Integrated Border Management and consider juxtaposing border facilities with neighboring countries. (£)
- Improve HR policies, including establishing a career path for customs officers. (£)
- Simplify procedures for trade of food products (£)
- Simplify local clearance by doing it on the premises of the importing company. (£)
- Give Customs Administration a larger role in setting customs policy. (£)
- Finish drafting inland customs clearance procedures. (£)
- Build an IT system that supports the entire customs reform program. (££)
- Align product quality standards and the tariff system with that of EU members. (£)