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Serbia Systematic Country Diagnostic Update

EUROPE AND CENTRAL ASIA REGION

Contents

Figures and Tables

Abbreviations and Acronyms

7STEEs	Seven Small Transition Economies of Europe (Bulgaria, Croatia, Estonia, Latvia, Lithuania, the Slovak Republic, and Slovenia)
CEE	Central and Eastern Europe
CEM	Country Economic Memorandum
CO2	Carbon dioxide
CoC	Chamber of Commerce
EC	European Commission
ECA	Europe and Central Asia
EU	European Union
FDI	Foreign direct investment
FSA	Financial Social Assistance
ICT	Information and communication technologies
IPARD	Instrument for pre-accession assistance for rural development
IT	Information technology
LGBTI	Lesbian, gay, bisexual, transgender, and intersex
NCD	Non-communicable disease
NPL	Non-performing loan
OOP	Out-of-pocket
PFM	Public financial management
PISA	Programme for International Student Assessment
PPP	Purchasing power parity
PPPs	Public Private Partnerships
R&D	Research and development
RSD	Serbian dinar
SCD	Systematic Country Diagnostic
SME	Small and medium-sized enterprise
SOE	State-owned enterprise
VET	Vocational education and training
WGI	Worldwide Governance Indicators
WTO	World Trade Organization

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Preface

The Systematic Country Diagnostic (SCD) examines the key constraints and opportunities to sustainably accelerate poverty reduction and boost shared prosperity. This SCD Update provides an update to the first comprehensive SCD published in 2015, titled "Serbia's Potential for Sustainable Growth and Shared Prosperity." The SCD Update reflects new important economic developments, includes an updated analysis of key constraints (informed by new data and recent developments), and updates the country's priorities. It focuses on the goals of sustained poverty reduction and shared prosperity and builds on available data and recent evidence, including the World Bank's Country Economic Memorandum (CEM) "Serbia's New Growth Agenda: Forging a New Future" (2019) and other analytical reports, including those reflecting the International Finance Corporation's priorities. The report is also informed by external consultations with the government, civil society, the private sector, development partners, and the academic community.

The SCD Update serves to inform the World Bank Group's next Country Partnership Framework and contribute to the country's policy dialogue. The 2015 SCD was a comprehensive document, with a detailed assessment of Serbia's development challenges. Although some progress has been made over the past five years, many constraints remain. This SCD Update is, therefore, intended as a concise report to capture the latest diagnostic. It provides a discussion of key issues, instead of covering all areas in depth, and references other sources for detailed sectoral analyses. At the time of concluding the SCD Update analysis, the COVID-19 global pandemic is unfolding with much uncertainty. The implications of the pandemic will likely be significant, which will be reflected in other subsequent analyses as the situation evolves.

Consistent with the 2015 SCD and Serbia's aspiration of converging to European living standards, the SCD Update considers countries in Central and Eastern Europe and the Baltics as the main group of comparators, particularly the seven small transition economies of Europe: Bulgaria, Croatia, Estonia, Latvia, Lithuania, the Slovak Republic, and Slovenia (7STEEs). European Union and Western Balkan averages are referenced, where data allows, to show frontier and regional comparisons, respectively.

1. Introduction

Serbia is a small, open, and upper-middle-income economy that aspires to reach European levels of prosperity. Serbia started its transition to a market economy in 2000 after a difficult decade of conflict, international trade sanctions, and economic mismanagement. The government implemented comprehensive reforms in the 2000s that, together with a favorable global economy, led to high economic growth and declining poverty until the global financial crisis hit in 2008. When the first Systematic Country Diagnostic (SCD) was prepared in 2015, Serbia was facing a fiscal crisis, rising unemployment, a decline in household income, and a stagnant economy, aggravated by floods and droughts. Serbia started negotiations for European Union (EU) accession in 2014 and converging to EU levels of income remains a key objective.

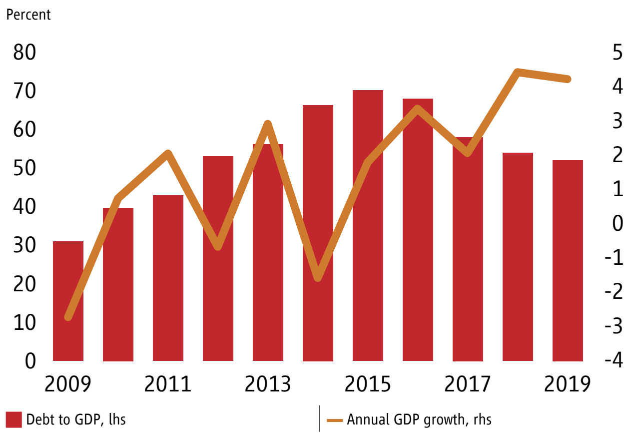
Since the first SCD, there have been positive economic developments, but important constraints remain, with the challenges for inclusion, sustainability, and resilience becoming more salient. Major fiscal consolidation and other reforms since 2014 have helped to restore macroeconomic stability and pave the way for the recent economic recovery and improvement in living standards. However, Serbia's economy in 2018 was still smaller than in 1990, indicating the need for further sustained and accelerated growth to catch up with comparators such as the 7STEEs. At the same time, a stronger focus on the key constraints to inclusion, sustainability, and resilience—which received less attention in 2015 because of the urgency then to stabilize the economy—is necessary today. Poverty and inequality levels in Serbia are still significantly higher than in comparator countries, with disadvantaged groups and subnational regions persistently lagging behind the average population. Environmental sustainability concerns have become more prominent, with pressing issues such as air pollution and an extremely carbon-intensive economy. Improvements in government effectiveness and accountability have stagnated in recent years, despite some reform efforts, holding back stronger progress across other areas. At the time of writing, the ongoing COVID-19 global pandemic reveals the need to further build resilience against a range of vulnerabilities of persons and institutions in Serbia.

Key Recent Economic Developments

The macroeconomic position has improved substantially since 2014. The government implemented an ambitious fiscal consolidation program in 2014–17 through revenue increases and expenditure adjustments. This included a public-sector hiring freeze, contained wage and pension spending through nominal reductions in both pensions and public-sector wages, and SOE reforms, including reduced spending on subsidies and guarantees for SOEs. As a result, Serbia managed to turn a fiscal deficit of 6.2 percent of GDP in 2014 into a surplus of 1.1 percent and 0.6 percent of GDP in 2017 and 2018, respectively.[1] Moreover, Serbia's public and publicly guaranteed debt was reduced from 71 percent in 2015 to 52 percent GDP in 2019, and the share of non-performing loans (NPL) dropped from 21.5 percent in 2014 to less than 5 percent in 2019. Interest rates are low, and private-sector credit growth started to turn positive in 2016. The restoration of fiscal and financial sustainability helped to reduce uncertainty for investors and consumers and create the conditions for economic recovery. Fiscal consolidation efforts have also put Serbia in a better position now than a few years ago to deal with shocks (e.g., COVID-19 outbreak), though these shocks are creating renewed risks.

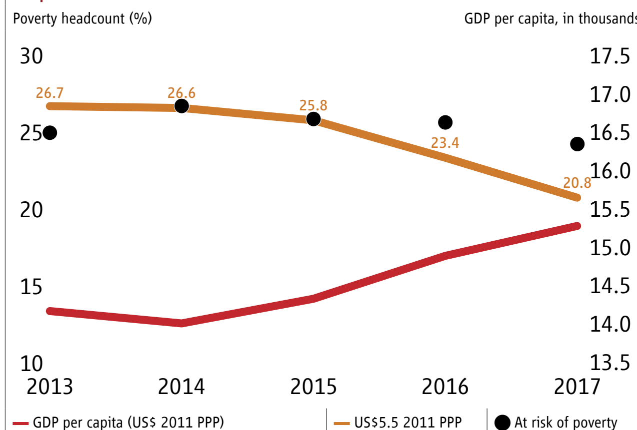
Economic growth turned positive, reaching an average of 2.9 percent in 2015–18 (Figure 1). On the supply side, economic growth has been mainly driven by services and, to a lesser extent, industry and agriculture. Serbia continues a gradual structural transformation away from agriculture and toward services. The share of agriculture in output and employment is on the decline, and services account for close to 60 percent of employment and around 62 percent of Gross Value Added. On the demand side, consumption and investment spending have been the main growth drivers in recent years, with a strong performance of foreign direct investment (FDI). In addition, exports grew from 45.3 percent of GDP in 2015 to 50.8 percent in 2018. The current-account deficit, at 5.2 percent in 2018, is low but widened to an estimated 6.7 percent in 2019, given the growth slowdown in the EU, Serbia's main export destination. Inflation has remained low at around 2 percent since 2014.[2]

Figure 1. Average economic growth increased while the public debt fell.



Source: World Bank staff calculations based on national government data.

Figure 2. Poverty declined due to economic growth and its impact on low-income households.



Source: World Bank staff calculations based on the Surveys on Income and Living Conditions (SILC). Data on household income, poverty, and inequality are shown for the reference year (the calendar year preceding the SILC survey year).

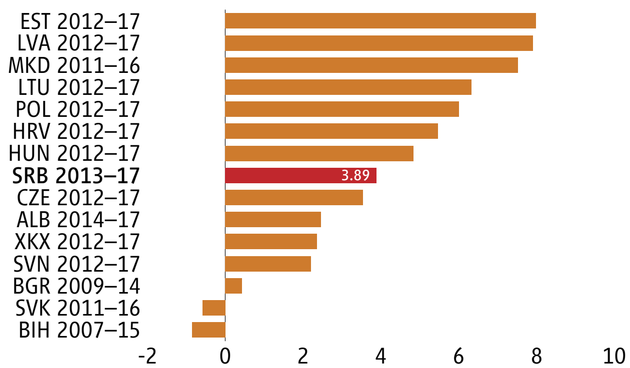
The labor market has recovered from post-crisis job losses. From 2014 to 2018, Serbia created around 240,000 net new jobs. The unemployment rate declined from close to 20 percent in 2014 to below 11 percent in 2019[3] (among people aged 15–64), and the employment rate now surpasses pre-crisis levels. Many of the new jobs have been full-time wage jobs in the formal private sector. Recent labor market improvements have also benefited women, older workers, and the youth. Job creation was the strongest in services and industry. Earnings increased alongside the number of jobs, as real wages in the private sector grew by more than 6 percent in 2014–17 and by more than 4 percent in 2018.

Poverty reduction resumed as a result. The poverty rate, measured as income per capita below the standardized upper-middle-income country poverty line of US$5.5/day in 2011 purchasing power parity (PPP), fell from 26.7 percent in 2013 to 20.8 percent in 2017 (Figure 2).[4] An increase of 1 percent in GDP was associated with about a 4 percent reduction in the poverty headcount rate, higher than the elasticities in neighboring Western Balkan countries. Consistent with the labor market recovery, increased labor income contributed the most to the observed reduction in poverty, followed by pensions. Household income increased and the poverty rate fell because of overall economic growth and its strong impact on households in the bottom of the income distribution.

Economic growth has disproportionately benefited rural and low-income households. In Serbia, the income of the poorest 40 percent grew by an annualized average of 3.9 percent between 2013 and 2017, higher than the income growth of 1.5 percent for the whole population (Figure 3).[5] At the time of the previous SCD, rural areas had been particularly hurt following the global financial crisis. Between 2013 and 2017, with economic and jobs recovery, the poverty headcount ratio decreased by 9.6 percentage points in thinly populated areas, 6.0 and 2.9 percentage points in intermediate and densely populated areas, respectively. However, thinly populated areas continue to house more than half of the country's poor.

Figure 3. The income of households in the bottom 40 percent has increased.

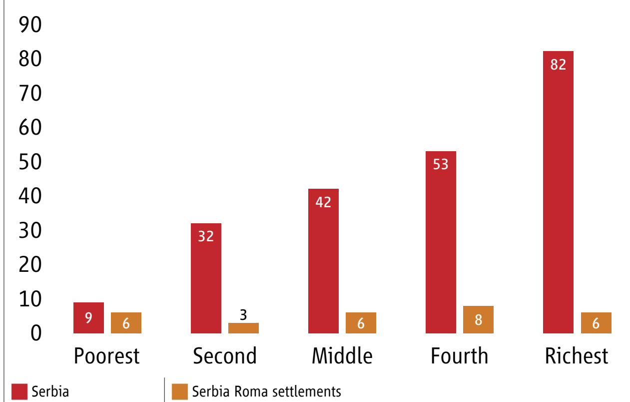
Annualized average growth of per capita income or consumption for the bottom 40 percent



Source: World Bank shared prosperity database.

Figure 4. Inequality of opportunity starts from an early age.

Share of children aged 36–59 months attending early childhood education by family income quintile (%)



Source: Serbia MICS 2014.

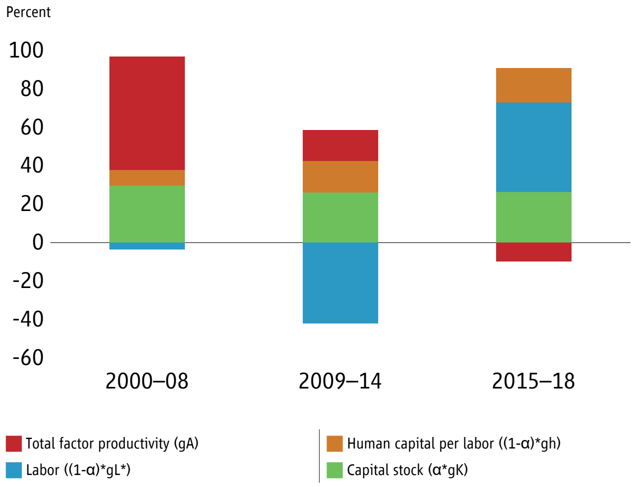
Faster Progress is Needed to Achieve Aspiration of European Prosperity

Despite progress in poverty reduction, vulnerability and inequality remain a concern for building a prosperous society. Almost one-third of Serbia's population lives on an income of US$5.5 to US$11 per day (in 2011 PPP) and is vulnerable to falling into poverty in the event of a shock. The middle class (i.e., households with economic security) is smaller in Serbia than in the EU.[6] Moreover, inequality in Serbia, though declining, remains high. The country's Gini coefficient of income[7] dropped from 38.3 in 2013 to 35.6 in 2017,[8] which still places Serbia among the three countries with the highest Gini coefficient when compared to Central and Eastern Europe (CEE) and the Baltics. There are strong spatial disparities in poverty rates and economic development across Serbia, with significant gaps between major economic agglomerations and lagging regions.[9] The estimated share of households at risk of poverty (i.e., households living on less than 60 percent of the national median income) ranged from 4.8 percent in Novi Beograd in the Belgrade region to 66.1 percent in Tutin in the region of Šumadija and Western Serbia.

Income inequality in Serbia reflects persistent gaps in access to opportunities. These inequalities of opportunities disadvantage Roma, women, the youth, and people living in Serbia's rural and lagging regions, often starting from a young age. For example, children of poor and Roma families are less likely to receive early childhood education, have lower educational attainment, and have fewer opportunities to earn a good income later in life (Figure 4). A high level of inequality, both across groups and across space, can potentially hamper economic mobility, growth, public trust in institutions, and social cohesion. Countries with higher inequality tend to have shorter periods of economic growth, and no country has managed to transition to high-income status while maintaining high levels of inequality.[10]

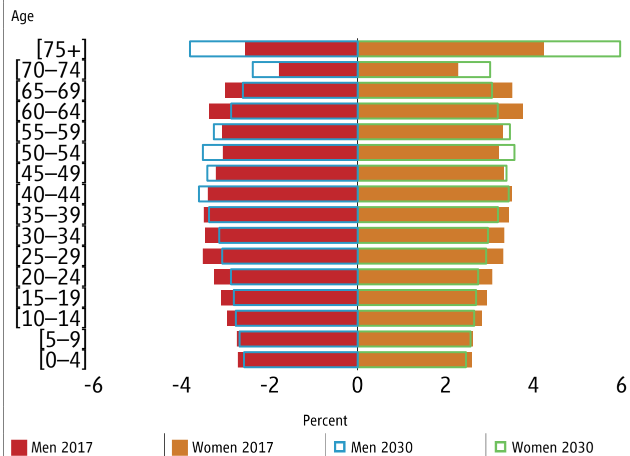
Serbia's recent economic progress is neither fast nor strong enough to catch up with Europe's living standards. The share of Serbia's population living in poverty (i.e., households with income per capita below US$5.5/day in 2011 PPP) was 20.8 percent in 2017, far above the range of 0.1–8.9 percent for countries in CEE and the Baltics. Similar to the analysis in the first SCD, the poor in Serbia are more likely to have less education, live in rural areas, be unemployed or self-employed, or work in primary occupations. Moreover, the share of the population considered at risk of poverty or in material deprivation (i.e., inability to afford basic housing, food, and durable goods) is also higher in Serbia than in comparator EU countries. Serbia's income per capita remains lower than that of comparator countries and is less than half of the EU average (Figure 7). Economic growth remains low and volatile and is below pre-crisis rates and the regional average. Investment spending averaged 18.8 percent of GDP over the past five years, which is below the level needed for sustained and high economic growth. Finally, Serbia's productivity is relatively low, and its contribution to GDP growth fell in 2015–18 relative to earlier periods (Figure 5).

Figure 5. The contribution of productivity to GDP growth fell between 2000 and 2018.



Source: CEM 2019.

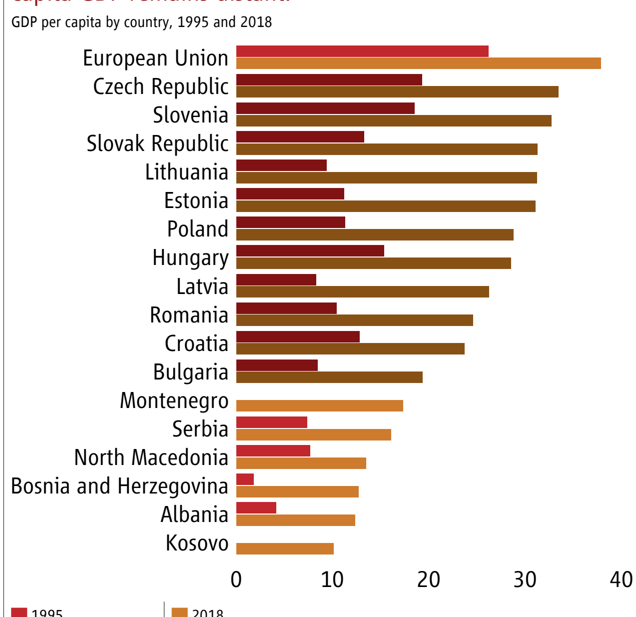
Figure 6. Serbia faces development challenges related to an aging population.



Source: World Bank estimates based on United Nations, Department of Economic and Social Affairs, Population Division.

While the government has advanced structural reforms, they are not sufficient to accelerate convergence with EU living standards. Serbia continues to lag behind countries in CEE on the European Bank for Reconstruction and Development's 2019 transition qualities score. Since 2014, the government has undertaken several important and useful reforms, including fiscal consolidation; reforms of some commercial SOEs and public utilities; efforts to strengthen public service delivery through administrative functional reviews; investment in early childhood education; making labor regulations more flexible; the creation of a legislative framework for disaster risk management; and digitalization efforts for government functions and service delivery. Serbia has also made notable progress in reforming business regulations for some functions such as construction permits and property registration. However, progress in implementing reforms related to market structure and governance has been slow.

Figure 7. Serbia's goal of reaching European levels of per capita GDP remains distant.



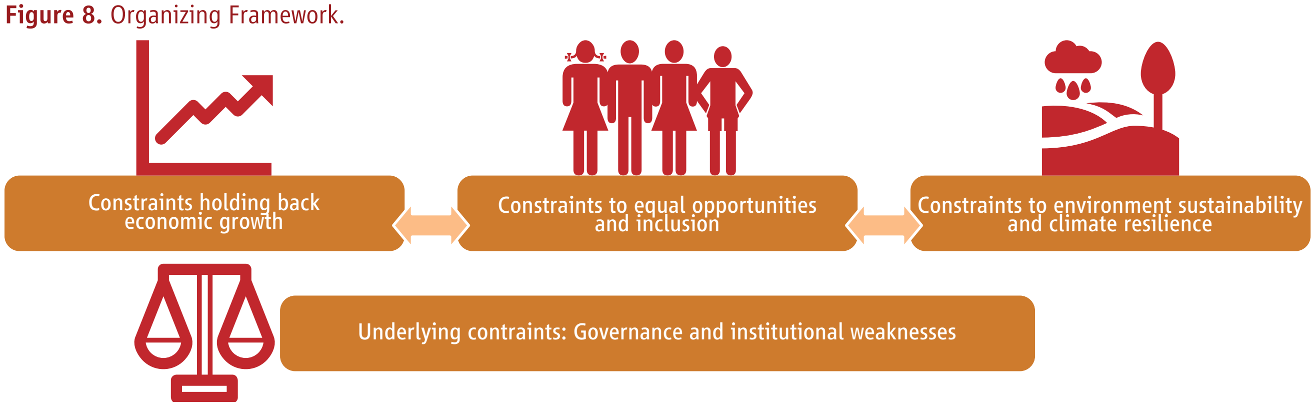
Note: In thousands US$ 2011 PPP.
Source: World Development Indicators.

Improvements in governance and institutions have stalled in recent years, holding back progress in other areas. In the early 2000s, Serbia made rapid gains in governance that supported and enabled its economic recovery. While gradual gains in governance continued until the time of the last SCD, further progress has since stalled. The World Bank's Worldwide Governance Indicators (WGI) show a mix of stagnating and declining trends since the 2015 SCD. The distance to Bulgaria, Croatia, Estonia, Latvia, Lithuania, the Slovak Republic, and Slovenia (7STEEs) remains at 20 to 30 percentage points for the six dimensions of governance covered by the WGI. The country's governance challenges also impact the country's ability to reduce inequality, address environmental challenges, and demonstrate progress on EU accession-related reforms (as reflected in annual EU assessment reports).

Addressing the key constraints to growth, inclusion, and sustainable development is critical for Serbia to achieve faster progress. The pace of poverty reduction and shared prosperity in Serbia has depended on the speed and inclusiveness of economic growth since the start of the transition. Having emerged from its fiscal and unemployment crisis, Serbia is ready to fully seize the opportunities for faster growth and poverty reduction. The 2019 Country Economic Memorandum (CEM) estimates that the country can achieve a GDP growth rate of 7 percent if a new growth agenda is adopted. A growth rate of 5–7 percent, instead of 3–4 percent, would double Serbia's per capita income in ten-to-fifteen years.[11] However, an increase in economic growth alone is not enough.

Environmental sustainability, resilience, and inclusion challenges have become more salient as emphasized in the SCD Update compared to the previous SCD. Without more equal opportunities and economic inclusion, there is limited potential for all citizens to thrive and become productive members of society. Welfare gains are vulnerable to economic downturns and uninsured risks. Growth with broad-based employment creation, coupled with equal opportunities for building key endowments and accessing jobs, is important for reducing poverty and boosting shared prosperity. Addressing environmental hazards and transitioning to a low-carbon economy would also be crucial for the well-being of current and future generations. Serbia's carbon dioxide emissions per GDP is about twice the 7STEEs average. Environmental challenges and climate-related factors, such as air pollution, high energy intensity, poor wastewater management, and droughts and floods, continue to pose significant threats to Serbia's development. These issues were overshadowed by the fiscal stress and job losses a few years ago but have now moved to the forefront of critical constraints facing Serbia.

Figure 8. Organizing Framework.



This SCD Update is organized around four main areas where constraints should be addressed, to: (i) achieve higher and sustained economic growth; (ii) provide equal opportunities to ensure inclusion; (iii) ensure environmental sustainability and manage climate-related risks; and (iv) improve institutions and governance (Figure 8). While some constraints related to post-crisis challenges, notably fiscal risks and rising unemployment, have lessened over the past five years, many structural constraints remain pertinent (Annex 1). Achieving higher economic growth requires tackling constraints to boosting productivity and private-sector development. Poverty reduction and shared prosperity require more and better opportunities for people to build key assets and participate in economic activities. Addressing environmental challenges and climate change is necessary to sustain progress and ensure long-term economic development. Governance and institutional weaknesses remain the underlying constraints to progress across sectors.

The framework of the SCD Update is similar to that of the 2015 SCD, with two adjustments. The previous SCD was organized around growth, inclusion, and macroeconomic, social, and environmental sustainability, with governance as a cross-cutting constraint embedded in the three pillars. Since 2015, macroeconomic sustainability has greatly improved while environmental sustainability remains a critical challenge. Therefore, the third pillar of the SCD Update focuses entirely on environmental sustainability and resilience. Moreover, the Update includes an in-depth discussion of Serbia's governance and institutional challenges, along with how these challenges constrain progress in other areas. This is important because progress in strengthening governance has weakened in recent years, and business, civil society, and development partners in Serbia are increasingly recognizing that weak governance is a major impediment to growth. As with the 2015 SCD, the framework's different areas are interlinked. For example, promoting inclusion and efficient service delivery can support and help sustain economic growth, and a growing economy can result in more public revenue for delivering public services. Also, environmental challenges and natural disasters adversely affect people's well-being and economic growth, while sustainable natural resource management, reduction of pollution, and climate action can support economic opportunities. While all the constraints affect progress, the SCD Update prioritizes the most critical constraints, which will be discussed in the last section.

A Changing and Challenging Context: Demographic Trends and Regional Relations

Serbia's population is aging and declining, with significant implications for growth and shared prosperity. The fertility rate has remained at 1.47 births per woman since 2015, and the population shrinks by about 38,000 people each year, or 0.5 percent of the total population. Given the low fertility rate and high out-migration, the population is expected to decline by 17 percent over 2015–2050,[12] and the labor force could decline by up to 20 percent by 2050. The share of the population over the age of seventy-five is increasing (Figure 6), which will put pressure on the country's pensions, healthcare, and social care systems. The extent of population decline is uneven across regions, with rural areas losing more people than urban, and several border areas are particularly affected by the population decline. Increasing labor market participation and worker productivity will be important to mitigate the potential adverse impact of a declining and aging population on economic growth and social safety nets.

Increased out-migration is contributing to the population decline, with potential impacts on economic growth and shared prosperity. While migration provides opportunities for migrants and remittances for their families, it can reduce the supply of workers and human capital available for domestic economic activities and service delivery. The positive impact of the diaspora and return migration is not yet clear. The annual net outmigration from Serbia to various high-income countries—especially Germany and Austria, but also the United Arab Emirates and others—has fluctuated between 10,000 and 20,000 people per year. Registered outmigration and remigration have increased in the past decade, particularly in 2014 and 2015. In addition, informal labor migration is likely to be substantial, given visa free access to the EU and the absence of incentives to de-register from residency in Serbia. There is a high level of interest in migrating, as Gallup's Potential Net Migration Index for Serbia is -25 percent overall and -46 percent among people aged 19–25. One-third of Serbia's youth expects to migrate after finishing school.[13] Both highly and less-educated individuals have migrated, according to the IAD brain-drain 2010 migrant stock data. However, rigorous and up-to-date data on the skills, occupation, and characteristics of migrants from Serbia are limited. Migration patterns and their impact, including their effects on domestic wages, competitiveness, and the long-term stability of the pension system, remain difficult to predict.[14]

Regional relationships play an important role in Serbia's development. The EU accession process remains important for the country's regional relations and domestic reforms. In the past few years, Serbia has joined initiatives to enhance regional economic integration such as the initiative on regional trade and transport facilitation, including the creation of single windows to submit documentation for import and export transactions[15], and the initiative taken in late 2019 by Albania, North Macedonia, and Serbia to ease cross-border trade and travel among them. Serbia is a member of the Central European Free Trade Agreement since 2007, which currently includes all of the Western Balkans and Moldova. Addressing cross-border challenges related to water and energy also requires regional coordination. For example, deeper cooperation across borders along the Sava and Drina rivers is necessary to lower investment costs, capture economies of scale, and minimize negative externalities. Beyond regional and EU relationships, Serbia maintains close political and economic contacts with the Russian Federation and China. The government also signed a free trade agreement with the Eurasian Economic Union in 2019.

The relationship with Kosovo remains difficult, and the prospect for resolution is uncertain. The Brussels Agreement was concluded in April 2013, which outlined the normalization of relations between Serbia and Kosovo. While initial steps were made to implement the agreement, progress has stalled in recent years. In November 2018, Kosovo imposed a 100 percent tariff on the import of Serbian goods as a retaliation to Serbia blocking Kosovo's prospects of joining the United Nations and other international organizations. Some renewed progress was made in early 2020 with agreements to restore transport links (rail, roads, and flights). The unresolved relationship risks absorbing significant policy attention to the detriment of focusing on the country's economic and social development challenges.

Serbia's main overarching foreign and economic policy goal is EU accession. While its strength as a driver of reform has lessened since 2015, increasing regulatory alignment remains important for facilitating trade and investments. Since the start of EU accession negotiations in 2014, Serbia has opened eighteen out of the Acquis Communautaire's thirty-five chapters as of March 2020. However, negotiations have progressed significantly slower compared to previous CEE accession rounds. Reasons for the weakening urgency of EU accession in Serbia include the relatively slow domestic reform progress (or even reversal in some areas), while at the same time, there is less enthusiasm among several existing member states for further EU expansion, which weakens incentives. In its 2019 annual monitoring report, the European Commission (EC) raised concerns about the functioning of the democratic political system, freedom of expression, the rule of law, and progress on economic reforms in Serbia, noting that "the institutional and regulatory environment remain weak."[16] Among Western Balkan countries, Serbian citizens are the most skeptical about EU accession, with 33 percent of them responding that it will never happen, significantly higher than the Western Balkan average of 20 percent.[17] In February 2020, the European Commission published outlines of a revised accession process, initially to be applied to new candidate countries, but with the option for existing candidates such as Serbia to opt in.[18] Even though the process has decelerated, alignment with EU regulations remains important given Serbia's proximity to and growing social and economic linkages with the EU. Trade, investments, environment, and labor markets are all areas in which there are close interactions with EU Member States and the EU's common market.[19]

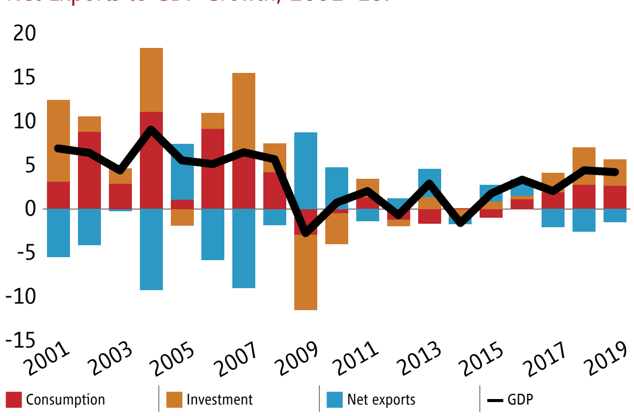
2. What is Holding Back Stronger Economic Growth?

Serbia's economic performance including fiscal trends, exports, and attracting FDI have improved, but resilience to renewed shocks, achieving productivity growth to enable better wages, and inclusion of more people in the labor market remain important challenges. As analyzed by the 2019 CEM, Serbia needs to improve its business environment, financial sector, education system, and competition policy to address these challenges. Stronger pro-growth policies need to be combined with maintaining hard-won macroeconomic stability and strengthening the effectiveness and accountability of governance, as well as inclusion efforts to sustain economic growth in the context of a shrinking population. Specific improvements needed in key enabling factors to improve resilience and accelerate growth are discussed in turn below.

Maintaining Hard-Won Macroeconomic Stability and Strengthening Governance as Preconditions

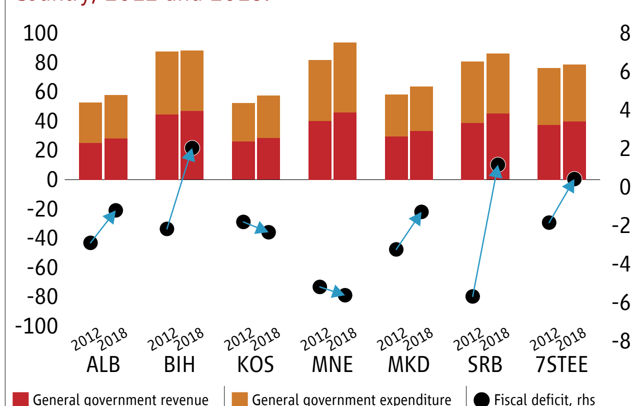
Over the past five to six years, Serbia has made laudable progress in addressing fiscal imbalances, but improvements in the composition of spending remained limited. As discussed earlier, Serbia saw the greatest fiscal adjustment across the Western Balkans in the 2010s, moving from a deficit of -6.8 percent of GDP in 2012 to a surplus of 0.6 percent in 2018 (Figure 10). Serbia's revenue to GDP ratio has been around 41 percent in recent years—in line with EU averages, but high relative to its current income level (Figure 10).[20] Especially relative to this high revenue level, Serbia has been spending little on public investments, and consistently less compared to CEE averages.

Figure 9. The Contribution of Consumption, Investment, and Net Exports to GDP Growth, 2001–18.



Source: World Bank based on Government of Serbia data.

Figure 10. Revenue, Expenditure, and Fiscal Balance by Country, 2012 and 2018.



Source: International Monetary Fund's World Economic Outlook.

There are continuing and new risks to sustaining macro-fiscal stability, and there is limited space to withstand new shocks. There is renewed upward pressure on public expenditures, including recently announced increases in public investments, public sector wages (planned to increase by 0.3 and 0.4 percent of GDP respectively in 2020), and expected new public sector hiring, as well as longer-term structural pressures related to an ageing society. While government debt was reduced (see Figure 1), it is still 21 percentage points higher than in 2009. At the same time, various potential fiscal risks remain. While the government established a fiscal risk monitoring unit since 2019, there is still no full assessment and monitoring of SOE-related risks (see also IMF 2019), and of contingent liabilities generally.[21] Furthermore, a global slowdown, as predicted in light of the impact of the spring 2020 corona virus disease (COVID-19), could simultaneously depress demand for Serbia's exports, limit FDI, reduce remittances (which accounted for around 6 percent of GDP in 2018[22]), and make banks even more cautious in lending to the private sector. Policy responses in Serbia to address the virus outbreak also require further resources from the state's budget via direct expenditures and deferred or forgone revenue to support economic activity and mitigate poverty and social impacts.

The trade deficit in goods and services increased in recent years (from 6 percent in 2016 to 9.9 percent in 2019).[23] Exports increased as a percent of GDP from 45 percent in 2015 to 52 percent in 2019, but imports grew even more. Serbia's trade relations are strongest with the EU—the country's main export market—while Russia and China are also important trade partners, albeit mostly in terms of imports. Serbia continues to remain outside the World Trade Organization (WTO), but it has several important Free Trade Agreements in place. Given Serbia's opportunity to access major markets, exports remain a key potential source of growth.[24] On the number of products exported and of export partners, Serbia performs better than the other Western Balkan countries, but below the 7STEEs.[25] The current account deficit has remained manageable given accelerating FDI inflows as well as significant remittances, but both of these may experience strain in the case of a renewed regional or global recession.

In addition to maintaining macroeconomic stability, authorities need to pursue governance reforms. Government effectiveness is an area that Serbia has made the least progress, as its distance to the frontier is the greatest among all indicators measured in the 2019 CEM, while it has the highest potential to contribute to additional growth.[26] Challenges related to policy coordination and strengthening public sector institutions (discussed further in section 5) affect the overall ability to pursue second generation reforms and to withstand shocks. Specific governance and accountability improvements are especially important to ensure the effective management of public investments, strengthen SOEs governance and performance orientation, enhance the quality of regulations and the business environment, and incentivize entrepreneurs to invest in the economy, as discussed further below.

Enabling Factor 1: Expanding Investments and Financing

Public and private investments are critical to achieve higher economic growth. While spending on both types of investments in Serbia has been low compared to peers, there have been signs of improvement in recent years. Authorities need to continue current efforts and implement new reforms to enable higher investment spending.

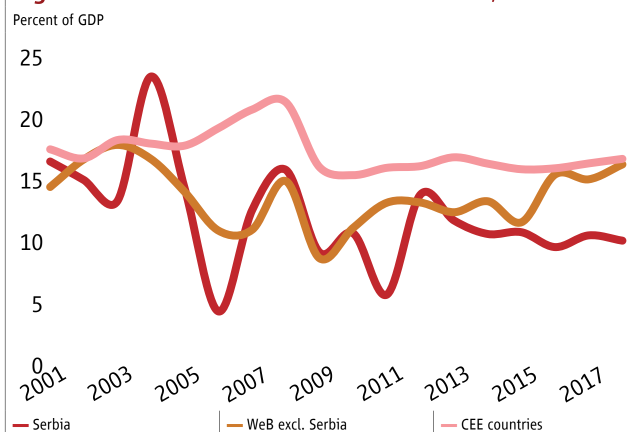
As public investment spending is beginning to recover, increased attention to the quality of investments is needed. Public spending on investments fell from 3.8 percent of GDP in 2008 to 2.5 percent of GDP in 2014, much lower than an annual average of 4.5–5 percent in the CEE in the same period. Public investment spending has started to recover, reaching 3.9 percent of GDP in 2018 and is estimated at 4.9 percent in 2019. As capital spending increases, new measures are being introduced in 2020 to ensure that funds are well prioritized and investment projects are appropriately prepared, although loopholes to circumvent these measures remain. Greater investments in new infrastructure needs to be complemented by attention to adequate and efficient spending on maintenance, and overall well prioritized expenditure management as outlined further below.

Public-Private Partnerships (PPPs) as an alternative way of funding infrastructure investments have remained limited thus far, despite the adoption of a PPP law in 2011. Two successful projects include the Belgrade Waste-to-Energy PPP project and the Belgrade airport concession, and small-scale PPPs have been concluded for the management of local public utilities. The Belgrade airport concession, concluded in late 2018 for a period of 25 years with a French concessionaire, included a one-time payment of EUR 501 million upon signature, a recurrent concession fee, as well as significant investments in the expansion of the airport. These initial projects signal the potential of PPPs, if project preparation and implementation capacities are further improved and if regional and domestic political risks are reduced.

FDI inflows have strengthened in recent years, although the stock of FDI remains still well below FDI levels in the 7STEE countries in per capita terms. Serbia's FDI net annual inflows relative to GDP surpassed the average of both the Western Balkans and the 7STEE for the first time in 2016. This achievement is linked to the adoption of specific policies to attract FDI,[27] leveraging Serbia's cheaper labor market compared to that of the new EU members. The country's overall level of FDI is still below the earlier peak in 2006, and the stock of foreign investments accumulated over time is significantly lower than in the 7STEEs.[28]

Contrary to trends for public and foreign direct investments, domestic private investments so far remain weak, also relative to regional peers (Figure 11). Serbia's domestic private investments averaged 10.5 percent of GDP in 2010-18, much lower than the average of 13.6 percent and 16.3 percent of GDP in the Western Balkans and CEE, respectively. Moreover, private investment spending is not yet showing signs of improving, due to a combination of financial sector constraints and of regulatory and governance challenges that dampen the business environment as further elaborated in section 2.3.

Figure 11. Domestic Private Investment Trends, 2001–18.



Source: CEM 2019.

The business community, particularly small and medium-sized enterprises (SMEs) and start-ups, point to access to finance as a major constraint on domestic investment spending in Serbia. According to the 2019 enterprise survey, access to finance was one of the top five most frequently cited business environment obstacles. Among the domestic firms included in the survey, only 52.3 percent used bank loans and 50.7 percent used supplier credit, with women-led companies slightly ahead of those with male top-managers.[29] Limited access to finance is partly due to the adoption of stricter lending criteria following the global financial crisis. A significant number of companies failed during the downturn, resulting in a substantial increase in NPLs, which took several years to resolve.[30] Unclear and insecure property rights, discussed further below, hamper access to collateral-based lending, especially among minority groups.[31]

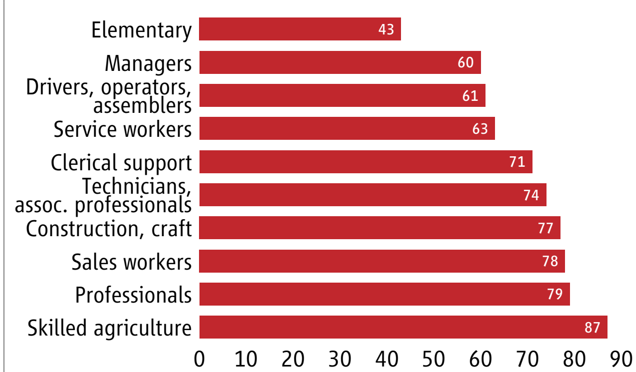
While there is a competitive banking sector, other forms of financing have either remained limited and restricted or not yet regulated in a way that enables transactions (e.g., microcredit, factoring, leasing, venture capital, private equity, crowdfunding). Opportunities for non-collateral-based financing, especially important for start-up companies, remains very limited, and Serbia's capital markets and institutional investor base remain underdeveloped. Moreover, an overly complex Law on Foreign Exchange Operations and 33 by-laws continue to restrict transactions that involve foreign credit operations (e.g., export financing, loans, payments, guarantees, deposits and settlements) and fintech development.

Enabling Factor 2: Human Capital and Worker Skills

Skills gaps have increased substantially since the 2015 SCD. According to the 2019 enterprise survey, inadequate access to skilled staff is now the second most frequently cited business environment obstacle.[32] The share of surveyed firms citing lack of workforce skills as an obstacle to doing business increased from around 2-3 percent in 2013 to close to 18 percent in 2019. According to employer survey data from the National Employment Services, the share of firms reporting hiring problems, mainly due to skill shortages, increased from 14 percent in 2014 to 29 percent in 2017. Most of the firms that were hiring had difficulty in finding the right workers, especially highly-skilled ones (Figure 12).

Figure 12. Most Serbian Firms Experience Difficulties in Hiring Workers.

Share of firms experiencing problems in hiring workers



Source: Serbia STEP Employer Survey.

Efforts in several directions are needed to address skills constraints.[33] Preschool education lays the foundation for acquiring cognitive and socioemotional skills, but Serbia's pre-primary education net enrollment ratio of 61 percent in 2017 is still lower than that of comparator countries in the EU.[34] Even though enrollment rates in primary and secondary education are high in Serbia, functional literacy remains low. More than one-third of students lack basic reading proficiency, according to the OECD's 2019 Programme for International Student Assessment (PISA). The country's general secondary education curricula had not been updated for two decades until 2018, when elective subjects were introduced.[35] Serbia has among the highest share of secondary students continuing to vocational education and training (VET)—74 percent compared to the EU and OECD average of 44 percent. However, Serbia's VET is more expensive than general education, and offers only limited pathways into post-secondary education. Accordingly, reforms to consider include expanding early childhood education; modernizing curricula; increasing the efficiency of the school system; streamlining and enhancing the relevance of VET and of higher education and improving access to and quality assurance of lifelong learning opportunities. In addition, integrating socioemotional skills becomes more important as employers increasingly value a combination of cognitive and job-specific technical aspects with those broader skills.[36] Skills constraints are part of broader labor market issues that remain a challenge for Serbia, as discussed further in Section 3.

In addition, there is significant scope to bring groups with underutilized skills into the labor force and address the drivers of out-migration. Women, older workers, and Roma still have low labor market participation rates in Serbia and a substantial number of working age citizens emigrate. Given the country's shrinking population, authorities need to seek enabling increased employment among these groups. Strengthening lifelong learning opportunities especially for these groups, addressing enabling factors such as connectivity (lower travel times being associated with higher likelihood of taking a job), facilitating within-country migration, and expanding child and elderly care are important factors. Opportunities for encouraging skilled citizens to remain in or return to the country should also be considered.

The quality of the country's health system is also important—both as a goal in itself and to ensure that healthy workers can participate productively in the labor force. Both the rate of and mortality from non-communicable diseases (NCDs) are significantly higher in Serbia than in the EU. Compared to the EU average, diseases of the circulatory system are more than twice as widespread in Serbia (82 cases per 100,000 people aged 0–64 in Serbia compared to an average of 38 in the EU), and malignant tumors are about 30 percent more common (100 cases per 100,000 people aged 0-64 in Serbia compared to 66 in the EU). Each year, Serbia loses more than an estimated 128,000 productive life years due to premature deaths from NCDs.[37] To address health-sector challenges, systems and processes need to embed a stronger focus on prevention and early detection of NCDs and increase efficiency to enable serving an aging population at an affordable cost. The COVID-19 global pandemic, which is unfolding at the time of completing this analysis, will put substantial pressure on Serbia's health system, like elsewhere in the world.

Adoption and implementation of education and health sector reforms, including public sector HR reforms, remain uneven. The number of teachers has expanded despite a decline in the number of students, while the health sector is grappling with worsening staff shortages as employees exit the public health sector. The government needs to carefully weigh funding options and create new funding mechanisms and incentives. Across the education as well as health sectors it will be important to monitor the effectiveness of policy initiatives, such as changes to curricula and pedagogical methods in education, performance payments in the health sector, and digitalization initiatives across both.

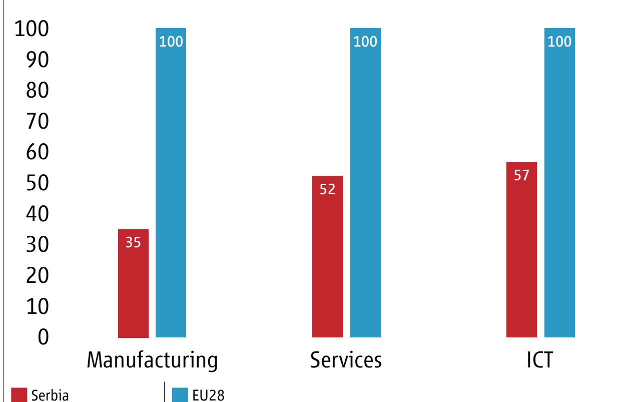
Enabling Factor 3: Productivity, the Business Environment, and Underlying Governance Constraints

The level of productivity in Serbia has been insufficient to accelerate economic and income growth. The labor productivity of manufacturing firms in Serbia is only one-third of that in the EU (Figure 13). A number of constraints contribute to holding back productivity growth, including misaligned FDI incentives, SOE governance, logistics and infrastructure constraints, lack of clarity and security of property rights and of regulations, and insufficient participation and transparency in decision making. Accordingly, these are areas of second-generation reforms to consider to further strengthen resilience and increase Serbia's growth potential.

Productivity gains are needed both within and across sectors to support the country's economic transformation. Serbia's labor productivity gap with peer countries is the largest in agriculture, with Serbia's agricultural productivity less than one-third of the average in the 7STEE and below the average of the Western Balkans. In industry and services, the country's performance is at par with the average of the Western Balkans but only about half of the average in the 7STEEs. Higher agricultural productivity and better job opportunities in other sectors would support a transition of workers to more productive activities and support overall productivity gains.

Figure 13. A Serbian manufacturing firm needs three times as many workers as the average firm in the EU to produce the same level of output.

Share of value added per worker, 2017, percent



Note: Services data include ICT, the latter also shown separately (third set of columns). Data on sole proprietorships are excluded for data on Serbia and included for data on the EU. Provisional data published on Eurostat that includes sole proprietors shows a wider productivity gap: Serbian manufacturing firms being four times less productive than their EU counterparts.
Source: 2019 CEM staff analysis, based on data from the Eurostat Structural Business Survey for EU countries and data from the Business Register Agency for Serbia.

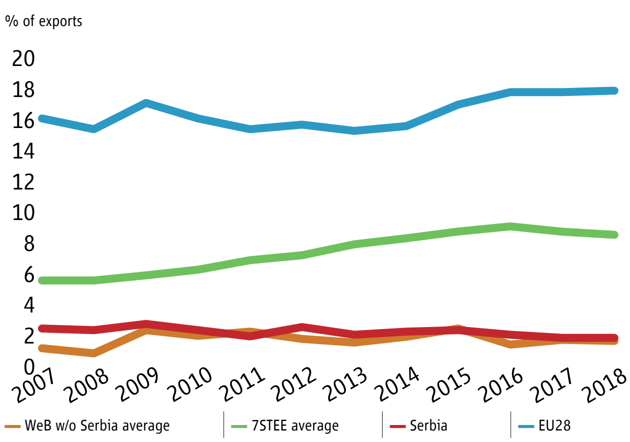
Even though agriculture is characterized by low productivity, it remains important for the overall economy and especially for the inclusion of rural areas. Food and agricultural products account for about 13 percent of the country's exports,[38] 17 percent of employment, and 7 percent of GDP. While most of Serbia's approximately 630,000 farms are small, the country's northern part (Vojvodina) has large farms, some of which are highly productive commodity producers focused mainly on cereals and oil-seeds.[39] There are also farms with competitive fruit production for export. The agriculture sector has had a net positive effect on growth and exports in recent years, although its weather dependence creates substantial volatility risks.

However, efforts to increase investment and productivity in agriculture continue to be hampered by land tenure uncertainty, the fragmentation of farms, and the incentive structure of agricultural subsidies. Large tracts of arable land continue to be owned by the state, including in zones with high production potential, and leased on one- to two-year terms, reducing incentives for longer term investments. In addition, extensive discretion in land use produces risks related to corruption in land allocation.[40] Recent estimates suggest that as much as one-third of state-owned agricultural land remains unused. A 2018 World Bank report on agriculture in the Western Balkans rates Serbia's agriculture sector as comparatively uncompetitive in terms of budget allocation, policy predictability, and institutions, while it remains competitive in terms of market development and access to capital.[41]

Attracting higher value-added FDI and promoting technological (including digital) upgrading and within-firm innovation can be an important driver of productivity gains. The recent increase of FDI in Serbia is encouraging, but so far has largely been in low value-added sectors. This is the result of policies designed to attract FDI to labor-intensive production to address high unemployment.

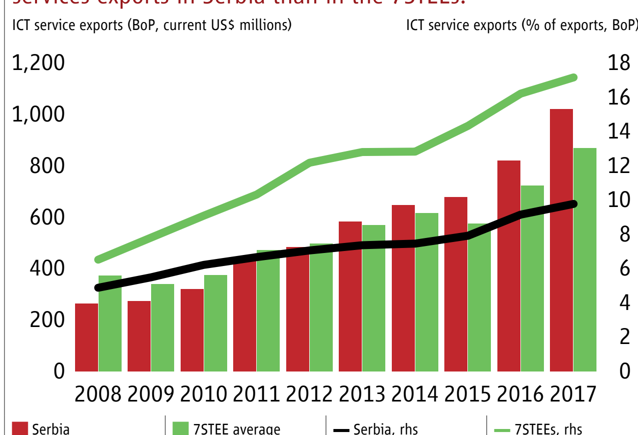
Productivity gains within firms are limited by low levels of innovation. The lack of innovation and effective digitalization among the majority of private companies constrains productivity increases. As a result, the overall export of high-tech products has remained low, falling from 2.8 percent in 2009 to 1.9 percent in 2018, which is significantly lower than the average of 8.6 percent in the 7STEEs (Figure 14).[42]

Figure 14. High-Tech Exports as a Share of Total Exports, 2007–18.



Source: Eurostat and authors' calculations.

Figure 15. ICT services constitute a higher share of total services exports in Serbia than in the 7STEEs.



Source: WDI database.

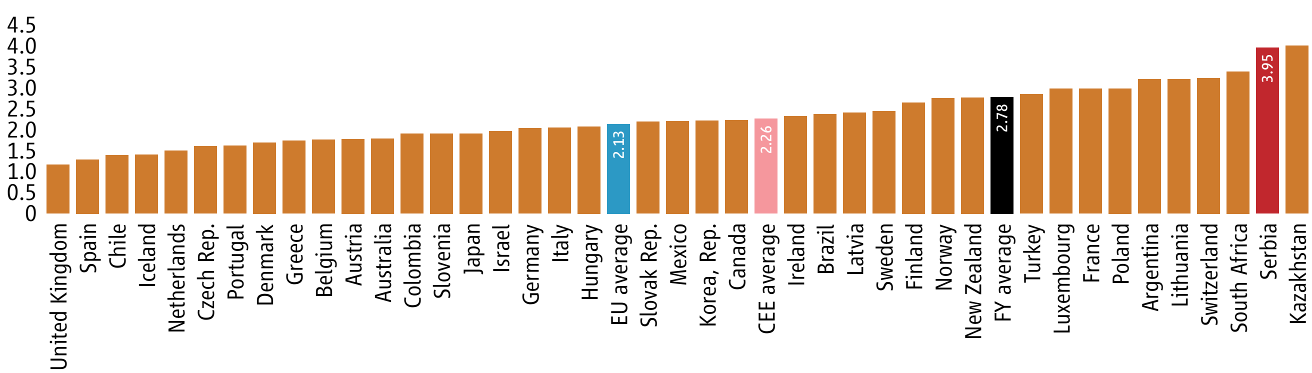
One sector of 'positive deviance' which has seen significant productivity and output growth since 2015 is the ICT sector. Serbia ranks among the top five countries worldwide in ICT talent on the Startup Genome list.[43] Digitalization efforts and measures to pursue digital value chains have increased overall economic growth in various former transition economies, including several of the 7STEEs.[44] Starting from a low base, Serbia's ICT services exports have increased rapidly in recent years, accounting for an increasing share of services exports (Figure 15), and reaching one fifth of services export in 2019, from a mere 6.5 percent in 2008. According to Serbia's statistical office, direct employment in the ICT sector grew from around 21,000 workers in 2016 to 33,700 in 2019.[45]

Enabling continued growth of the sector is important, including due to the potential contributions to productivity growth in other sectors via digitalization of processes and interfaces and reduced transaction costs. Continuing growth in the ICT sector will depend on the availability of relevant skills and balanced regulation, as well as further expansion of connectivity.[46] The annual output of information technology (IT) graduates was estimated at 1,500 in 2018,[47] well below recent annual employment growth of the ICT workforce. Developing the country's ICT sector and digitizing the society have been key policy goals of the government in recent years, including plans to increase the number of IT graduates to 5,000 per year. Achieving this will require sustained actions in secondary and post-secondary education, combined with strengthening systems of lifelong learning. In addition, regulation and taxation of the ICT sector requires careful calibration, for example, regarding the criteria and tax category that applies to many ICT workers, as well as appropriate regulation on competitive safeguards and cybersecurity. Especially outside of main urban areas, digital connectivity requires further expansion.

Another sector with renewed attention is mining, given substantial geological potential; the sector can especially benefit remoter areas and contribute to increasing exports—however, environmental risks and related negative spillovers need to be well regulated and managed. There are areas in Serbia with substantial mining potential, for which authorities need to further pursue balanced and effective regulation to develop the mining industry in a sustainable way. Since the 2015 SCD, over US$1 billion[48] has been invested by the private sector in exploration activities across 140 fields in Serbia. There is a large-scale deposit of copper and gold in Cukaru Peki and another one of lithium and borate in Jadar. Based on preliminary estimates, the contribution of mining to GDP could grow from 1 to 5 percent if a significant number of new mines was developed—which has been slow so far by complex and partially outdated permitting processes. The mining sector has the potential to generate needed public revenue and create opportunities for remote areas if risks related to the environment and social impacts are effectively addressed. Furthermore, fiscal transparency of sector related revenue will become important as it begins to expand further.

Since the 2015 SCD, important progress has been made on SOE reforms. In 2014, direct subsidies, government guarantees, and SOE arrears all created high fiscal costs and risks, amounting to 3, 6 and 8 percent of GDP respectively. Over the following years, over 500 companies were resolved, a majority of 312 through bankruptcy.[49] By 2018, 55 companies had been privatized, and additional privatizations were realized in 2019; while fiscal costs and risks were reduced—with some year-by-year variations. State aid gradually declined from 2.2 percent of GDP in 2016 to 1.9 percent in 2018 but is still well above the EU recommended limit of 1 percent of GDP.[50]

Figure 16. There are many sectors in Serbia with state-owned enterprises.



Source: CEM Product Market Regulation paper.

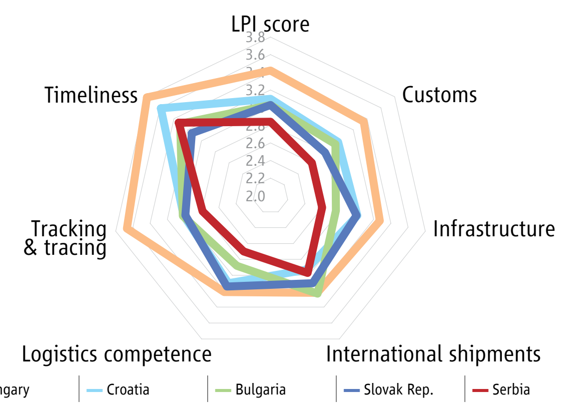
However, as many sectors still have a significant presence of state-owned enterprises (SOEs), further governance and regulatory reform is important (Figure 16). Enterprises fully or partially owned by the state remain dominant across network and infrastructure sectors, including electricity, gas, fixed and mobile telecommunications, postal, transport—

including roads, cargo and passenger rail services, insurance and banking.[51] Water, sewage, and waste services are managed by municipal public utilities, and there is still substantial state participation in the forestry and mining sectors. Other sectors with significant state ownership include publishing and media, health, construction, administrative services, and agriculture. SOEs enjoy preferential treatment in terms of substantial state aid and regulatory enforcement.

The continuing large presence and preferential treatment of SOEs in Serbia affects competition and productivity. SOEs dampen productivity with their own inefficiencies, and when they are shielded from full competition, private companies face greater hurdles to offer alternatives. For example, partly as a result of the dominance of SOEs in Serbia's energy sector, the country ranked 94th out of 190 countries on getting electricity[52] in the World Bank's 2020 Doing Business report, far behind countries such as the Slovak Republic (54) and Slovenia (23). According to a comparative analysis by the IMF, if Serbia's SOEs achieved private sector productivity levels, they could increase their output by nearly 14 per cent, contributing to a one-off expansion of GDP of 2 percent.[53]

In addition, the management and governance of SOEs has continued to be an issue of concern despite the adoption of a new Law on Public Enterprises in 2016.[54] Following general elections, the management of SOEs has often been changed to align with the incoming administration. The 2016 law was expected to end this practice by requiring open competitions for the selection of managers. However, many of the remaining national SOEs have been headed by acting managers, sometimes for years (see also IMF 2019). This limits their independence to manage operations and may induce decisions that reduce productivity.[55] According to the IMF's Corporate Governance Index, Serbia is ranked 15th out of 20 countries in Eastern Europe and Central Asia. To limit the adverse impact of SOEs on overall economic development, the authorities need to ensure balanced regulatory treatment of SOEs, transparent and merit-based selection of managers, clear incentives for managers to focus on productivity and performance, and transparent financial reporting.

Figure 17. Serbia underperforms in several areas of the Logistics Performance Index.



Note: The Logistics Performance Index ranges from 2 (lowest ranked country) to 4.2 (highest ranked country).
Source: Logistics Performance Index 2018.

Spatial planning and clarifying land holdings have significantly lagged behind actual developments and negatively affect security of property rights, resulting in significantly higher risks compared to the 7STEEs (Figure 18). Weaknesses in spatial planning and permitting have slowed development and have resulted in 4.3 million structures that have either not been registered in the real estate cadastre or are registered but the building characteristics (such as size) do not match the cadastre records[56], and in an inability to reap the full benefits from the introduction of measures such as the one-stop shop for construction permits. In addition, there is still limited inclusive and integrated urban planning: citizen participation has so far remained weak in the planning or renewal of urban areas. While the government is tackling these issues and adopted a Sustainable and Integrated Urban Development Strategy in June 2019, greater progress is still needed. Aligning the spatial planning efforts of different government authorities and coordinating sector-level plans within cities would help to ensure better and more efficient and accountable municipal management. Following the adoption of the Law on the Planning System of the Republic of Serbia, bylaws have been prepared for the implementation of mid-to-long term regional and local development plans.

Addressing the country's logistics constraints is critical to effectively connect Serbia's small open economy to larger regional and global markets. In 2018, Serbia's Logistics Performance Index ranking in customs, logistics infrastructure, logistics competence, and tracking and tracing was below that of Hungary, Croatia, Bulgaria, and Slovak Republic (Figure 17; see also the 2019 CEM note on 'Exporting to Grow'), with limited progress noted since 2012. On the Doing Business Indicators, Serbia performs better, being ranked 23rd globally with regard to 'trading across borders' (unchanged since 2015).[57]

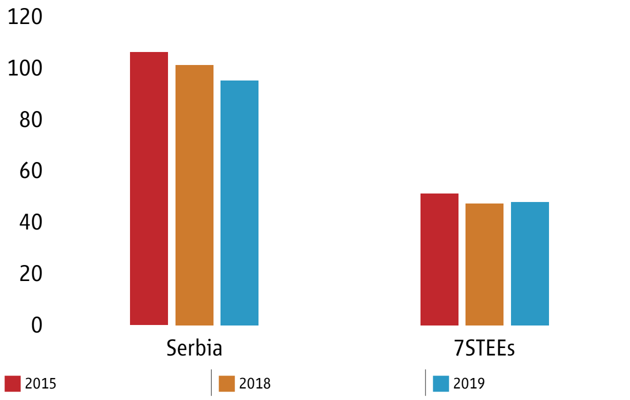
Regarding infrastructure aspects, expanding transport infrastructure and mobility services remain constrained by multiple deficiencies. According to the 2019 Global Competitiveness Report, Serbia ranked 98th on the quality of roads and 82nd on the efficiency of train services out of 141 countries. Actual implementation of infrastructure upgrading has progressed slowly mainly due to the lack of a strategic framework, weak planning and preparation process, and institutional as well as industry modernization needs. Inefficient SOEs involved in public infrastructure have contributed to bottlenecks. For example, despite significant investments in the road sector, Serbia was only able to complete 25km of new highway per year (250km in total) from 2009 to 2019. While the government has focused on building new infrastructure, resources for maintaining and upgrading the transport networks have been insufficient (while gradually increasing) and maintenance practices remain input based without clear prioritization and results-orientation. Reforms initiated in the railway sector need to advance further. The introduction of contractual arrangements between the government and SOEs, including increasing monitoring of the impact of expenditures, provides an opportunity.

Serbia's main urban areas are less dynamic than those in comparator countries, making them a weaker 'engine' of overall growth. The country's three largest cities—Belgrade, Novi Sad, and Nis—have a total population of about 2.3 million, and Belgrade alone accounts for 40 percent of GDP and 35 percent of jobs.[58] However, the capital's economic performance has been less dynamic than that of metro areas in other countries with similar characteristics. For example, the average annual GDP growth was around 4.9 percent in Bucharest and Sofia in 2003–17 due to strong productivity gains, compared to an average of 3.4 percent in Belgrade in the same period.

Following several years of stagnation[59], from 2015 onwards, there was a renewed push to improve the business environment as attracting foreign investments was one of the main priorities of the new government. The government established a cross-ministerial high-level working group chaired by the Deputy Prime Minister to improve Serbia's performance on Doing Business. The working group prepares and updates an Action Plan and then closely monitors and coordinates its implementation. As a result, Serbia's business environment as measured by the Doing Business rankings significantly improved: compared to 91st in 2015, on the 2020 Doing Business Report, Serbia achieved an overall ranking of 44th out of 190 economies. Significant progress was noted in protecting minority investors and resolving insolvency, and especially on construction permits where regulatory changes to simplify the process were adopted and electronic processing was created. As a result of reforming construction permitting, Serbia's ranking on this sub-indicator of the Doing Business Index improved from 186th globally in 2015 to 9th in 2020. The number of construction permits issued increased significantly over the past five years.

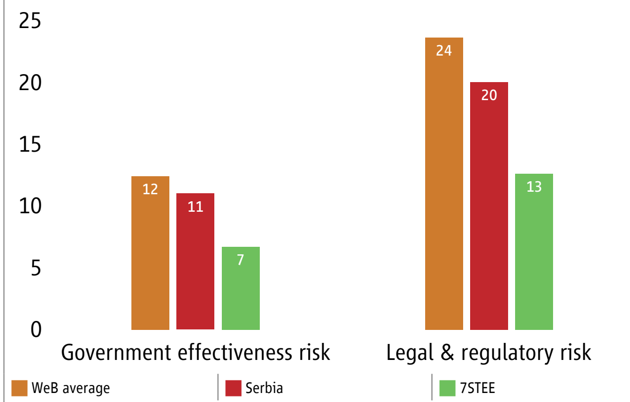
However, while Serbia has made progress in improving its business environment, important governance, institutional, and regulatory constraints remain, and some of these especially affect SMEs and their ability to contribute to inclusive growth. Perceived risks related to property rights and regulations remain substantially higher in Serbia than in the 7STEEs, according to the International Property Rights Index and the Economist Intelligence Unit Risk Tracker (Figure 18 and Figure 19). Also, there is a lack of competitiveness in public sector procurement with a low average number of bids signaling a lack of trust in the system. Furthermore, according to the 2019 enterprise survey, 16.6 percent of firms indicate that "political instability" is the biggest obstacle to doing business in Serbia (choosing among a set of 15 pre-defined items).[60] Policy unpredictability has been noted by business associations as a challenge.[61]

Figure 18. International Property Rights Index.



Note: Countries are ranked from 1 (best) to 129 (worst).
Source: International Property Rights Index global ranking

Figure 19. Government Effectiveness and Legal and Regulatory Risks.



Source: Economist Intelligence Unit Risk Tracker, October 2019.

Serbia's business environment continues to be affected by inefficient regulations and public bureaucracy, corruption, and weak channels for businesses to voice their needs, and some of these challenges especially affect SMEs. The 2017 World Economic Forum survey shows that tax rates and regulations, an ineffective bureaucracy, corruption, and frequent policy changes are among the greatest obstacles to doing business in the country. The World Bank's Doing Business 2020 report shows that the average number of tax payments in Serbia (33 payments) is more than twice the regional average (14.4 payments). Domestically owned businesses report significantly greater challenges related to tax rates and the tax administration compared to foreign-owned firms, according to the 2019 enterprise survey. In the same survey, mid-sized firms (20–99 employees) report a higher share of senior management time spent on dealing with regulatory requirements, identified business licensing and permits as a constraint, and reported 'gifts' required for import licenses compared to large firms. Small firms (5–19 employees) reported a requirement for gifts to obtain construction permits and electrical connections at higher rates.

There are concerns from both business associations and the EU that policy changes are too frequent and often unpredictable in Serbia. Relatedly, rules and regulations are often viewed as too cumbersome and non-transparent, and there are limited consultations with the business community ahead of regulatory changes.[62] It can be challenging for businesses to obtain clear and timely regulatory guidance when rules are incomplete or contradictory. Guidance on the interpretation of laws and by-laws is typically given on a case-by-case basis, rather than made available online for all businesses to use. This contributes to a complex and unclear business environment, pointing to greater transparency and participation as important issues for businesses and ultimately for increasing productivity.

While surveys show that Serbian companies express some confidence in courts and existing laws, they also indicate that the judiciary is seen as not sufficiently independent, and efficiency remains limited.[63] According to the 2018 report of the European Commission for the Efficiency of Justice (CEPEJ), first-instance courts have a clearance rate of 93 percent for civil and commercial cases, meaning that the number of incoming cases is higher than the number of resolved cases. The European's Commission's 2019 report on Serbia notes that the highest number of backlog cases (86.6 percent of the total) are in basic courts. As courts struggle with the incoming case load, judicial decisions are slow, lagging the regional average by about 120 days for enforcing contracts, according to the 2020 Doing Business report. Slow-moving courts, coupled with decisions often made on procedural rather than substantive grounds, have a negative impact on the country's businesses. The issue of judicial independence is addressed further in section 5.

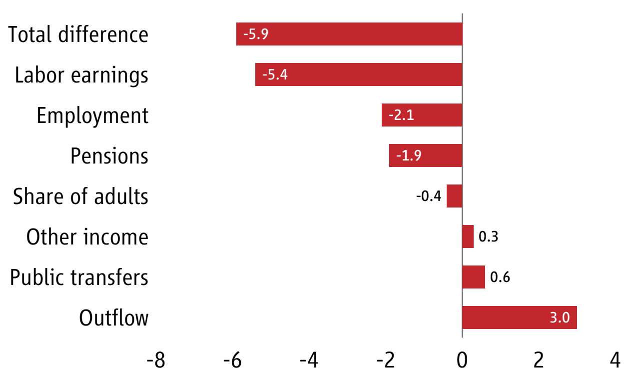
3. Equal Opportunities and Inclusion

Building a prosperous society with European living standards is only possible if Serbia promotes equal opportunities and inclusion. Better opportunities for all to build human capital and participate in productive work are critical for lifting more people out of poverty and sharing the benefits of economic growth. Citizens need opportunities to earn better income through salaried jobs, self-employment, or agricultural jobs. To maximize income from work, people need access to education and health and protection from destitution and from shocks. While Serbia's employment rate has improved, many people are not working. In addition, access to quality basic services remains unequal. Addressing the key constraints to employment, equity, and efficiency of services—including the underlying institutional and governance challenges—would help to reduce regional disparities and overall inequality. Promoting inclusion and service delivery can also contribute to higher economic growth through more efficient use of human capital.

More and better-paid jobs are critical for stronger poverty reduction and economic mobility. Higher labor income was the biggest contributor to poverty reduction in Serbia in 2013–17, and efforts to maximize job opportunities remain the most important and sustained way to reduce poverty in the long term (Figure 20). Yet, Serbian households continue to rely on social transfers, as labor earnings constitute only roughly half of total household gross income. Households in the bottom 40 percent of the income distribution, with less education attainment, have worse employment outcomes. Poor workers are more likely to have low-skilled jobs: 63.3 percent are employed in elementary occupations, craft, or primary sector occupations. Households in the bottom 40 percent also depend less on income from salaried employment (34 percent of total income) and more on self-employment (15 percent of total income) than households in the top 60 percent of the income distribution (47 and 6 percent, respectively).

Figure 20. Labor income was the main driver of poverty reduction.

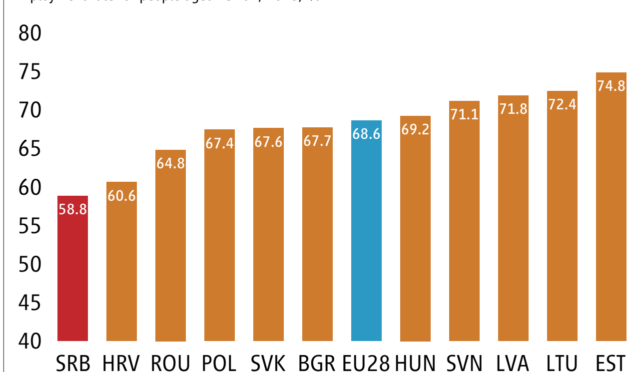
Contribution to poverty reduction, 2013–17, percentage points



Source: Authors' calculations based on the Survey on Income and Living Conditions.

Figure 21. Employment is lower in Serbia than in neighboring European countries.

Employment rate for people aged 15–64, 2018, %



Source: Serbia LFS; Eurostat, World Development Indicators.

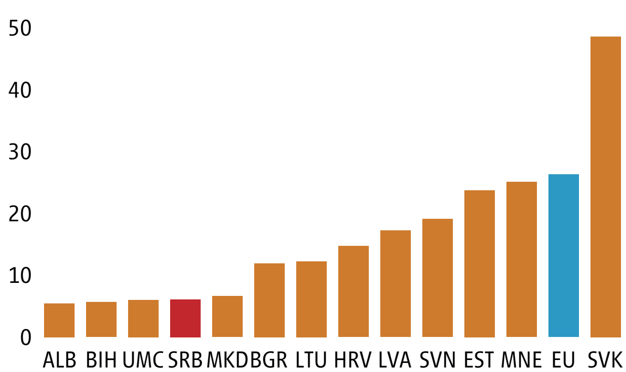
Despite recent labor market improvements, many people in Serbia are not working or searching for a job. Among people aged 15–64, Serbia's activity rate (67.8 percent) and employment rate (58.8 percent) remain far below those of neighboring EU countries (Figure 21). Inactivity and unemployment are even worse among poor households: only 22.4 percent of the working-age poor are employed, compared to 53.0 percent of working-age non-poor. As a result of inactivity and unemployment, the average male and female worker in Serbia loses about 20 years and 25 years, respectively, of his and her potential productive lifetime (ages 15–64). Many job seekers are long-term unemployed: 75 percent of unemployed workers wait more than one year to find a job. Serbia is underutilizing its full potential workforce while firms demand more workers with the right skills. With a declining working-age population due to aging and outmigration, it is important that Serbia uses its available workforce effectively.

Constraints in the labor market and work disincentives continue to hinder employment. Public-sector and informal employment represents 28 percent and 20 percent, respectively, of total employment, which means that only about 30 percent of Serbia's workers aged 15–64 are employed in the formal private sector. Private sector employment is constrained by a clear preference for working in the public sector, as shown in the Balkan Barometer data, given more stable contracts and a public sector wage premium. High labor taxes and contributions, particularly for low-wage and low-skilled workers, create high costs for employing them formally. The design of social assistance also reinforces barriers and work disincentives (e.g., by taking away one Serbian dinar (RSD) in benefits for each RSD earned), and activation of social assistance beneficiaries remains limited. The government can improve job matching by enhancing monitoring and evaluation and the effectiveness of active labor market programs implemented by the National Employment Services. Internal migration is lower in Serbia than in other transition economies, indicating potential for facilitating within-country labor mobility to move to jobs.[64] Although Serbia made labor regulations more flexible in 2014 (including reforms of fixed-term contracts and employment termination provisions), further efforts are needed to address new forms of work and better support gender equality. In addition, the slow pace of productivity growth limits the potential for a robust increase in labor earnings.[65]

Low labor productivity in agriculture limits poverty reduction and catching up of rural areas with the rest of Serbia. 21.3 percent of poor workers are employed in the agriculture sector, compared to 6.2 percent of non-poor workers. However, value-added in agriculture in Serbia is only about one-third of that in other small transition economies in Europe, constraining the scope for raising income (Figure 22). Similar to the situation in the 2015 SCD, productivity and investment in agriculture are limited by land tenure uncertainty, the fragmentation of farms, and the incentive structure of subsidies, which reinforces fragmentation rather than incentivizing innovation and technology adoption. Challenges related to land rights, local governance, and policy coordination further hold back the agriculture sector and the potential of rural development (further discussed in section 2).

Figure 22. Serbia's agricultural productivity is relatively low.

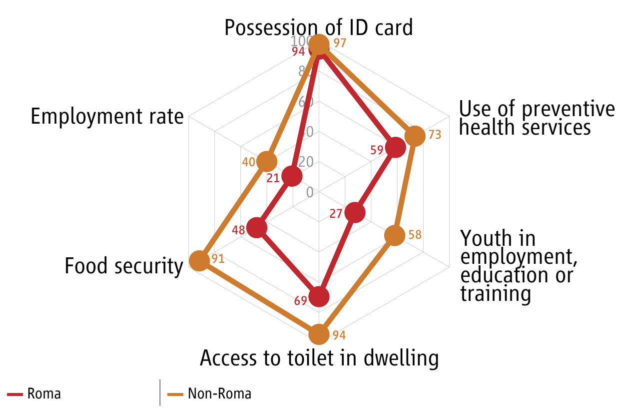
Value-added per agricultural worker, 2017 (in thousands)



Note: In constant 2010 US$.
Source: World Development Indicators.

Figure 23. Roma people in Serbia continue to face multiple challenges.

Human capabilities and material well-being in Serbia, 2017, percent



Source: World Bank and UNDP estimates based on 2017 UNDP-WB-EC Regional Roma Survey data.

Regional disparities underscore the unequal access to opportunities in Serbia and the challenges of lagging regions. Average per capita household income varies widely in the country, from RSD 544,555 in Novi Beograd to RSD 156,060 in Tutin municipality.[66] The large spatial disparities in welfare raise concerns about equity, social cohesion, and can result in lagging regions getting locked into long-term low-growth paths. Ten of Serbia's twenty-five NUTS 3 regions are considered low income (i.e., they have a per capita GDP below the national average), while four regions are classified as low growth.[67] Lagging low-income regions also have high levels of poverty, poor human development outcomes, and high gaps in terms of infrastructure service delivery and quality of municipal services (particularly water and wastewater treatment). While raising the competitiveness of Serbia's leading urban agglomerations will contribute to economic growth, addressing the challenges of regions left behind will be critical to achieve shared prosperity and sustainable growth.

Addressing the challenges of lagging regions would require equitable service delivery, enhancing connectivity, and promoting economic opportunities where there is potential. Ensuring access to high-quality public services is important to build human capital, regardless of where people live. Individual endowments such as education and household characteristics accounted for more than half of income disparities between urban and rural areas and between the capital city and the rest of the country in Serbia. Efforts to assist lagging regions also need to include strategies to enhance economic opportunities in high-potential regions and effectively deal with population decline in low-potential regions. For those lagging regions with growth potential (depending on their economic geography characteristics and sectoral comparative advantage), strengthening the enabling environment for business and reducing market access barriers would help promote economic opportunities and attract and retain young people.[68]

In addition, improving within-country transport connectivity, linking remote and poorer areas with more dynamic ones, would help to facilitate labor mobility, market access, access to services, and job opportunities. Improving such accessibility is especially important for poor and disadvantaged groups that rely more on public transport services.[69] However, municipal transport infrastructure and services are constrained by the lack of capacity and resources at the local level. Improving good governance at the local level can accelerate local development,[70] and there is a need to increase transparency and effectiveness at the subnational government level, especially in terms of roles and responsibilities and the allocation of resources.[71]

Young and lesbian, gay, bisexual, transgender, and intersex (LGBTI) people have fewer opportunities and are at risk of social exclusion. Even though the unemployment rate among youth fell from 43 percent in 2015 to 35 percent in 2018, it remains double the EU average, constraining their long-term employment prospects. Moreover, around one-fifth of the population aged 15–24 was not in employment, education, or training, which is high by international standards. LGBTI people have also reported that they face discrimination and hostile work environments.[72]

As highlighted in the 2015 SCD, Roma people remain at a disadvantage and face multiple barriers to material well-being. In the past decade, Serbia has made some progress on Roma inclusion, such as an increase in birth registration and primary education enrolment; affirmative measures for Roma students' enrollment in secondary and tertiary education; and the introduction of Roma teaching assistants and health mediators, as well as coordinators for Roma issues. However, significant challenges persist. Compared to the non-Roma population, Roma are less food secure, use less preventive health services, and are less likely to possess an identification card (Figure 23). Regional Roma survey data also show no progress in pre-primary enrollment among Roma children between 2011 and 2017. In 2017, only 9 percent of marginalized Roma children aged 3–5 were enrolled in pre-primary education, which constitutes the second largest gap in the Western Balkans and is significantly less than 28 percent of non-Roma children. The government's ongoing Inclusive Early Childhood Education and Care project, implemented with the World Bank's support, will benefit all preschool children, particularly those from poor and minority backgrounds.[73] Though improving, compulsory school age enrollment rates and unmet medical needs are worse for Roma than for their non-Roma neighbors. Cost and lack of awareness are important barriers that keep Roma children out of school.

The employment rate among the Roma population is only half that of the non-Roma population. Additionally, Roma youth are less likely to be employed or receive education or training than their non-Roma counterparts. If the employment and earnings gap between Roma and the general population in Serbia was closed, the total gains from increased productivity could range from 0.9 percent to 3.5 percent of GDP.[74] Despite improvements in overcrowding and access to essential services such as electricity and piped water among marginalized Roma, gaps remain wide. Non-Roma had an overcrowding rate of 22 percent in 2017, 43 percentage points lower than that of marginalized Roma. Also, economic reintegration is much more difficult for Roma returnees from the EU due to discrimination, their low levels of education and professional skills, and their limited social capital.[75] An integrated approach in several policy areas—education, labor market, health, housing and access to essential services, and documentation—continues to be necessary to promote Roma inclusion.[76]

Although Serbia has made progress in promoting gender equality,[77] large gender gaps persist, particularly in access to economic opportunities. The Gender Equality Index for Serbia increased in 2014–16 but remains 10 points lower than the EU average.[78] While the labor force participation rate for women reached 60.6 percent in 2018, it remains 14.5 percentage points lower than for men, and women's employment rate of 52 percent is still 13.7 percentage points lower than that of men. The difference in labor market activity between men and women may reduce Serbia's per capita gross income by 16 percent.[79] Only 18.2 percent of firms in Serbia have top managers who are women, and only 28.5 percent of firms have part female ownership, according to the 2019 enterprise survey. Women also earn around 17 percent less than men, even when characteristics such as education and work experience are accounted for.[80] This situation is even worse among Roma women, as they experience additional barriers associated with traditional gender norms that promote early marriage and relegate women to domestic chores, child rearing, and care for elderly or sick relatives. These gender norms prevent Roma girls from accessing higher levels of education and, in turn, better labor market prospects. Almost 30 percent of Roma girls married before they turned eighteen, and the upper-secondary and tertiary completion rates are extremely low for Roma women in Serbia.[81]

Limited access to affordable quality care, the structure of labor taxes and regulations, and social norms constrain women's access to income-generating opportunities.[82] Although fathers are entitled to family leave, because of social norms about gender roles, oftentimes mothers take maternity and childcare leave and stay out of the workforce longer. Lack of access to property can be an obstacle to develop a business and access finance. Only 39.2 percent of property owners in Serbia are women, and limited ownership of farm land coupled with traditional gender norms can limit women's decision making in rural areas.[83] As in many countries, qualitative studies in Serbia have found that discrimination in hiring, social norms about gender roles, and limited access to affordable care services constrain women's ability to work.[84] Gender disparities across fields of study in tertiary education also contribute to occupation segregation and differences in labor market outcomes between women and men. Women account for 84 percent of graduates in education, 75 percent in health, and 69 percent in arts and humanities. However, they make up only 43 percent of graduates in science, technology, engineering, and mathematics.[85] Violence against women is also a concern, as over one-fifth of Serbian women aged fifteen or older report having experienced physical or sexual violence.[86]

Promoting economic inclusion requires more equitable and efficient service delivery for all citizens to build key productive assets. Serbia's main human development outcomes are good relative to its income level. Serbia ranked 27th out of 134 countries on the Human Capital Index in 2019—higher than the average of both Europe and Central Asia (ECA) and upper-middle-income countries. However, Serbia underperforms countries in CEE and the Baltics on several other education, health, and sanitation indicators. Poor, rural, and vulnerable groups (including Roma and LGBTI people) also face various challenges in accessing health and education.[87] Despite recent efforts to improve efficiency through functional reviews in social sectors, many reforms of service delivery systems remain only partially implemented or delayed. The combination of weak efforts in streamlining procedures, a decline in meritocratic hiring, and staffing caps has a negative impact on service delivery.

An unequal and inefficient education system constitutes a barrier to inclusive growth. Despite high overall enrollment rates, poor and vulnerable groups are at a disadvantage in terms of both enrollment and achievement levels, starting in early childhood education. Around 80 percent of children in the top income quintile attend more than one year of pre-primary education, compared with only 10 percent of those in the bottom income quintile (and even less for Roma).[88] The number of preschool spaces available, parental attitudes, and the cost of preschool education all influence enrollment in preschool. In particular, the 20 percent co-payment requirement for preschool makes it less affordable for poor households. Enrollment in general compulsory education among the poorest Roma is only 66 percent, compared with almost universal for the general population, though some affirmative measures have been introduced to facilitate enrollment of Roma students in secondary education.[89] Students from poor households and rural areas continue to perform below the national average on the 2019 PISA.

Efficiency improvements in the education sector are held back by systematic issues such as school funding based on inputs; slow modernization of the curriculum and skills development, including the need for stronger development of socioemotional skills; high VET enrollment, with significant mismatches between supply and labor market demand, and high costs; and weak accountability in higher education.[90] It is difficult for policymakers in Serbia to evaluate the effectiveness of policies, including efforts to digitize schools and evaluate teacher and student performance, as information and monitoring and evaluation systems are underdeveloped. There is a need for effective school network rationalization, which has been discussed for several years.[91] Governance of the country's technical and vocational education and training and higher education systems needs improving to ensure that students are equipped with skills in demand in the labor market.[92]

As raised in the 2015 SCD, high out-of-pocket (OOP) health expenditures limit access to and affordability of healthcare, particularly for poor and disadvantaged groups. OOP payments accounted for 40.5 percent of the country's total health expenditure in 2016, higher than the average of the 7STEEs and the Western Balkans and significantly higher than the recommended threshold of 15-20 percent. About 58 percent of OOP payments are spent on drugs, with limited regulations on the use and pricing of prescriptions. High OOP payments can deter the poor from seeking necessary medical services, impoverish near-poor families, and push poor households deeper into poverty. In 2015, 8.5 percent of households in the poorest income quintile reported unmet medical care needs due to financial reasons, compared to less than 1 percent among households in the richest quintile, according to Eurostat.[93]

Serbia's health service delivery model has not adapted to deliver value-for-money despite recent reforms, for example, performance-based contracts with health care providers, centralized procurement of drugs, and e-prescription. Serbia's total health expenditure amounted to 9.1 percent of GDP in 2016, higher than the average of 7.3 percent in the 7STEE and 8.4 percent in the Western Balkans. Serbia's life expectancy, infant mortality, and under-five mortality rates are comparable to those in the 7STEE. However, the maternal mortality rate (12.0 deaths per 100,000 live births) is much higher in Serbia than in the 7STEE (average of 8.7deaths) and the EU (average of 6.0 deaths). Serbia's service delivery model is focused on curative care rather than more cost-effective preventive care, and the provider payment system is still mainly input-based, with limited incentives for quality and efficiency. As an indicator of low efficiency, the average hospital stay in Serbia (10.0 days) is significantly longer than in the 7STEEs (7.2 days) and the EU (8.2 days). Moreover, high rates of NCDs contribute to rising healthcare costs and social expenditures related to illnesses. In 2016, more than 6.2 percent of GDP was spent on disability benefits and paid sick leave. Improving efficiency will be critical to manage the expected rising costs and increased demand for health services due to population aging.

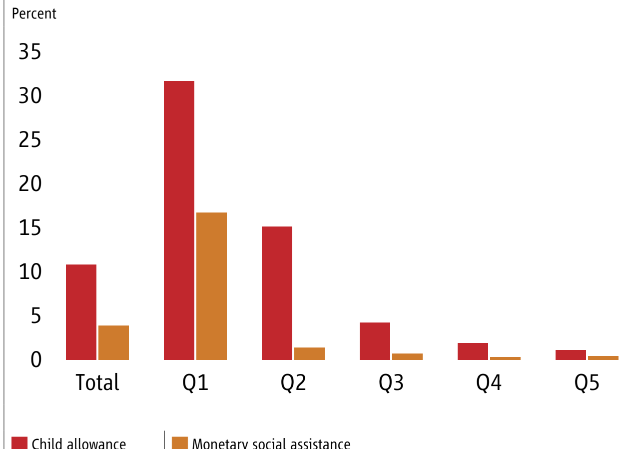
There are overlaps and gaps in the governance of the health system. Lack of planning and coherent regulations in the public and private health sectors prevent an integrated oversight of healthcare providers. As a result, there are gaps and bottlenecks in service provision, contributing to inefficient use of resources and high OOP payments. The government adopted the Health Care and Health Insurance Law in April 2019, which returned the ownership of primary care facilities from the municipal to central government level, as municipal management had been inadequate in many regions. Authorities can improve governance through a combination of greater autonomy and accountability, including the implementation of information systems and measures to monitor and incentivize better performance.[94] Moreover, corruption in the health system, which 77 percent of Serbian citizens think is an issue (according to the 2019 Balkan Barometer), jeopardizes the affordability and quality of care. Out-migration can potentially affect workforce skills and service delivery, particularly of health workers.[95]

Relatively poor sanitation and waste management, particularly in poor municipalities, results in environmental and health risks. Access to water supply and sewerage systems in Serbia is linked to municipalities' household income levels (Figure 24). Serbia performs worse than comparator countries in safely managing sanitation services. More than 80 percent of Serbia's urban population has a sewer connection, compared to 20 percent of the rural population. Only 12 percent of the population is connected to urban wastewater systems, and urban wastewater is not adequately treated (discussed further in section 4).

Figure 24. Access to sewerage services is less in poorer municipalities.

Source: Western Balkans Territorial Review.

Figure 25. Coverage of Means-Tested Social Assistance by income quintile, 2017.



Source: World Bank staff calculations based on the Survey on Income and Living Conditions.

Social assistance is important for low-income households, although its impact is limited by low coverage. Social assistance accounts for around 16 percent of the income of households in the bottom 40 percent of the income distribution. By international standards, the country's main poverty-targeted programs—the Financial Social Assistance (FSA) and child allowances—are well-targeted to poor households.[96] However, only 17 percent of people in the poorest income quintile are covered by the FSA (Figure 25). While this rate has increased in the past few years, coverage remains very low, which affects the effectiveness of social assistance in reaching and supporting the poor. While the new Law on Financial Support to Families with Children has focused on maternity leave and child grants and the ongoing development of the Social Card system, reform efforts have not yet addressed the low coverage of social assistance programs. Spending on non-means tested programs remains more than three times the spending on the means-tested FSA and child allowances.[97]

Reform efforts have been hampered by weak institutional capacity and lack of policy coordination. For example, there has been limited progress on consolidating social benefits, expanding means-tested programs, and implementing efforts to increase the activation of beneficiaries. In addition, social service provision, for example, institutional care, requires further improvements. The aging and declining population creates an additional burden on social assistance through pressures to spend on categorical benefits intended to boost fertility and increased needs for elderly care. Ongoing efforts to develop the country's health information system need to be coupled with a clearly defined institutional framework, accountability, and information management arrangements to fully benefit from the digitalization of the social protection sector.

The financial sustainability of Serbia's pension system has improved since 2014, although uncertainties remain. Pension reforms in 2014 reduced early retirement and introduced temporary reductions of pensions (thereafter abolished in 2018), which reduced pension costs to less than 11 percent of GDP in 2018 and restored financial sustainability. However, the valuation of points and ad hoc indexation of pensions, subject to budget availability, led to a gradual decrease in the value of pensions.[98] The average old-age pension fell from 67 percent of the average net wage in 2013 to 59 percent in 2017. Serbia's aging population will put further pressure on the country's pension system.

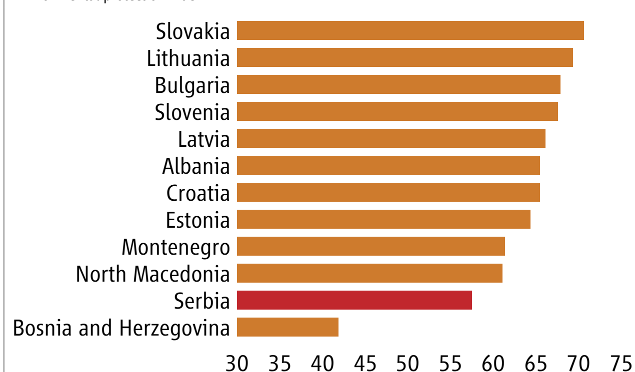
Continuing system reforms aimed at improving service delivery efficiency will be important for promoting inclusion in a fiscally sustainable way. A careful analysis of the distributional impact of fiscal policy and tax and spend measures would inform efforts that strengthen the redistributive and poverty impact of government policies within the fiscal envelope. Examples include increasing the progressivity of the labor tax and mandatory contributions and improving the coverage of targeted social benefits. Strengthening policy coordination and governance effectiveness is necessary to increase the cost-effectiveness of service delivery and implement unfinished reforms.

4. Environmental Sustainability and Climate Action

Serbia faces major environmental challenges and climate-related risks, which calls for a stronger agenda to improve the country's resilience to and mitigation of climate change. Serbia is prone to natural disasters such as floods and droughts, which can cause significant damage to infrastructure, the economy, and people's livelihoods, especially among vulnerable groups. Climate change may intensify the frequency and scale of natural disasters. Meanwhile, low efficiency in energy, transport, water, waste management, and agricultural practices results in a high carbon footprint, significant losses of extracted water, and elevated levels of air pollution in major cities like Belgrade, Subotica, and Niš. Pollution and poor environment management overall in turn impact economic growth and people's welfare through, for example, reduced productivity, poorer health outcomes, and reduced learning capacity. Overall institutional strengthening, policy development, and enforcement are necessary to strengthen Serbia's environmental sustainability and climate action. Investment and institutional capacity needs are large, especially to expand and improve environmental infrastructure, including in the urgent areas of waste and wastewater management, pollution control, and transition to cleaner energy. Serbia also needs to reduce and manage environmental liabilities in the mining sector. Addressing the country's environmental challenges and pursuing climate action are critical to achieve sustainable growth, accelerate poverty reduction, and transition to a low-carbon economy.

Figure 26. Serbia lags peer countries on environmental protection.

Environmental protection index

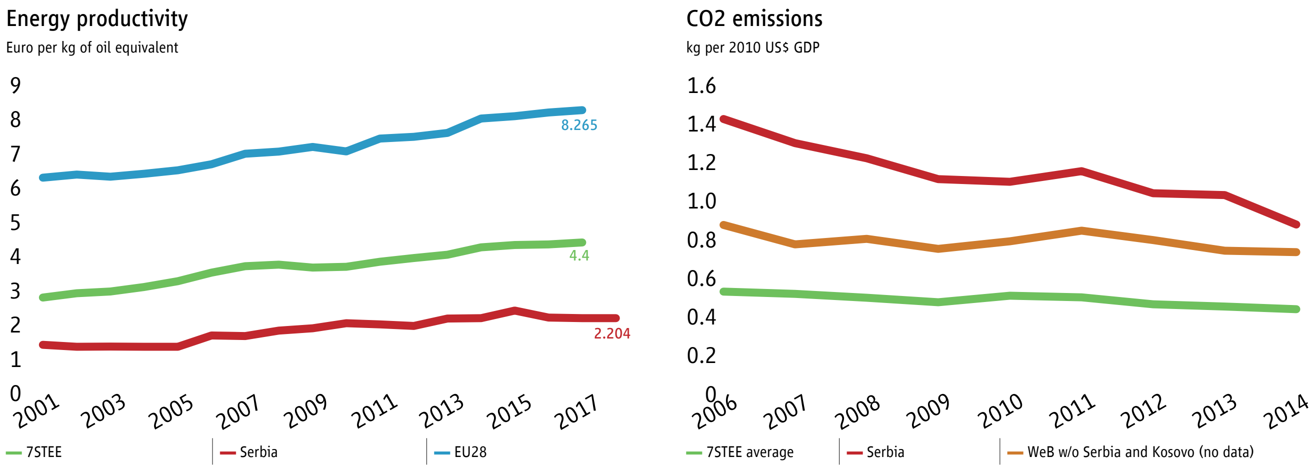


Note: The Index ranks 180 countries on twenty-four performance indicators across ten issue categories that cover environmental health and the ecosystem vitality.
Source: Environment Protection Index 2018.

Serbia lags peer countries in overall environmental performance, as raised in the 2015 SCD. The Environmental Performance Index shows that Serbia's score on environmental health and ecosystem vitality is lower than that of all European comparator transition economies, with the exception of Bosnia and Herzegovina (Figure 26). Serbia's water withdrawal rates (as a share of internal water resources) are higher than not only the average of the EU but also the average of the ECA and upper-middle-income countries, suggesting high and inefficient use of water to support economic activities. Serbia's carbon dioxide (CO2) emissions per unit of GDP (in PPP terms) are above the average for the rest of the Western Balkans and much higher than the 7STEE average. In particular, the intensity of CO2 emissions in Serbia's energy sector is high, mainly due to a significant share of outdated power plants using low-quality fuel. According to data from the International Energy Agency, Serbia's reliance on domestic lignite (about two thirds of energy mix in power generation) is the main cause for the high carbon footprint. Moreover, the country's energy productivity, measured as the amount of economic output per unit of available energy, is only one-fourth of the average in the EU (Figure 27).[99]

Environmental threats—the most critical being poor air quality and wastewater treatment—adversely affect peoples' health and livelihoods as well as the economy. Air pollution is the fourth-leading risk factor for premature deaths worldwide, contributing to 1 in 10 deaths and resulting in significant losses of welfare and income. Serbia has higher estimates of premature death due to air pollution than most countries in the EU, estimated at 6,592 premature deaths and 131,183 years of life lost.[100] The main sources of air pollution in Serbia are in energy (lignite-based electricity and heating), transport, and industry: thermal power plants, oil refineries, chemical facilities, and metal and mineral industries. In addition, solid fuel for domestic heating, agricultural waste burning, inadequate storage and disposal of by-products such as ash from power plants, and tailings from open cast coal mines all contribute to the high level of air pollution. In 2018, eight areas in Serbia had air pollution above limits: Belgrade, Subotica, Niš, Pančevo, Užice, Valjevo, Kraljevo, Sremska Mitrovica, and Kragujevac.[101] Only Pančevo and Belgrade have air quality management plans. While other countries have, on average, halved their emissions since the beginning of this century, emissions in Serbia have remained the same or increased, depending on the type of pollutant. In 2015 (last available data), the emission of sulfur dioxide per capita was higher in Serbia than the CEE average by 350 percent, suspended particles by about 70 percent, and by 30 percent for nitrogen oxides, carbon monoxide, and organic substances.[102]

Figure 27. Low energy productivity contributes to high CO2 emissions.

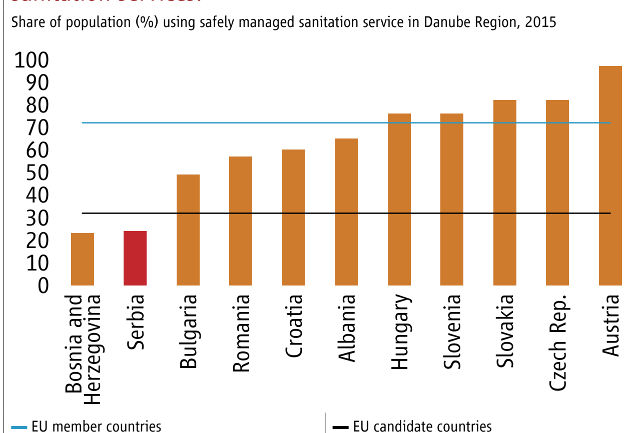


Source: Eurostat.

Source: World Development Indicators.

Serbia's water quality, solid waste management, and wastewater treatment remain relatively poor. Only one-quarter of the country's population uses safely managed sanitation services, and around 12 percent of the population is connected to wastewater treatment facilities (Figure 28). Most small communities with fewer than 2,000 people do not have wastewater treatment plants, and eighteen out of the existing fifty plants are not operational. Municipal and industrial waste in Serbia is left predominantly untreated, and documentation and control systems for industrial waste are underdeveloped. The absence of a system to control for hazardous industrial waste in streams is alarming, posing toxic health hazards. Dated and inefficient waste and wastewater infrastructure and lack of financing, institutional capacity, and awareness have held back faster progress in protecting environmental health. The Waste Management Strategy for 2019–2024 marks a major shift from the model of regional sanitary landfills to regional waste management centers, which include waste sorting, separation, and recycling, as well as non-recyclable waste treatment.

Figure 28. Serbia has relatively low access to safely managed sanitation services.



Note: Safely managed sanitation services are defined as "private improved facility where fecal wastes are safely disposed on-site or transported and treated off-site; plus a hand-washing facility with soap and water." No data reported by JMP for Kosovo, North Macedonia, Moldova, Montenegro, or Ukraine.
Source: WHO/UNICEF JMP Database 2017.

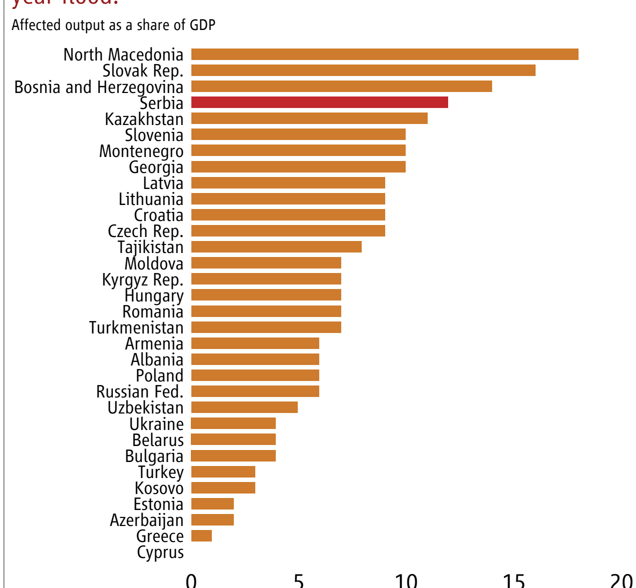
Serbia's environmental challenges are among the factors that reduce the livability and competitiveness of its cities. Belgrade does not have a wastewater treatment plant, and its current waste pickup, sewerage, and water coverage rates (85 percent, 72 percent, and 91 percent, respectively) fall short of what is needed for a well-functioning city with a rising population. Authorities need to prioritize the upgrading of aging infrastructure and improve public service delivery to offset current and impending costs of congestion and increase the attractiveness of cities. Investing in urban amenities—such as quality affordable housing, public services, and reliable local roads and infrastructure—would also improve the potential of Serbian cities to drive economic growth.[103]

Serbia faces major institutional and financial challenges to improve environmental management.[104] Since the early 1990s, the Ministry for Environmental Protection has been restructured numerous times, and it became a separate ministry only in 2017. The ministry suffers from a lack of staff and has struggled with implementing efficiency-enhancing measures, including establishing IT systems and streamlining functions. A number of environmental strategies and policies are currently being updated at the national and subnational government level. The government needs to prioritize the efficient management of large-scale public investments to improve waste and wastewater management and treatment, as well as to ensure that projects managed by other stakeholders comply with environmental standards. Moreover, authorities need to improve inspection and enforcement capabilities (including judicial institutional strengthening), which are critical to enforce compliance, notably related to industrial pollution. Investment and institutional needs are also urgent for investing in emissions control for existing thermal power plants and phasing in alternatives to lignite-fueled electricity generation.

Strengthening institutions as well as mobilizing and effectively implementing public investments will be needed to comply with EU environmental and climate directives. The management of wastewater and waste in Serbia does not meet EU standards. While implementation plans for EU water directives have been prepared, the country lacks the capacity to meet legislation requirements. Additional investments in the water supply, wastewater treatment, and flood protection are also needed to comply with EU accession requirements in the coming years. With respect to the environment, there has been slow progress in transposing EU legislation (chapter 27) into domestic laws and implementing measures to protect the environment (especially at the local level).

Serbia is prone to natural hazards such as floods, landslides, droughts, earthquakes, and wildfires that can have a significant impact on people and infrastructure. The number of people affected by flooding is estimated at about 200,000 on average per year, at an estimated cost of US$1 billion in GDP. Serbia ranks fourth among ECA countries in output affected by a 100-year flood (Figure 29).[105] The risk posed by climate change is high for Serbia, as the country ranked 8th in 2017 and 35th in 2018 out of all countries on the German Climate Risk Watch Index in terms of losses relative to GDP. Major floods in May 2014 caused damages equivalent to 2.7 percent of GDP and pushed an estimated 125,000 people into poverty. More recently, parts of central and western Serbia were affected by heavy rain and flash floods in June 2019, with twenty municipalities declaring a state of emergency. The government launched a national disaster risk management program in December

Figure 29. Serbia ranks high in output affected by a 100-year flood.



Source: GFDFR.

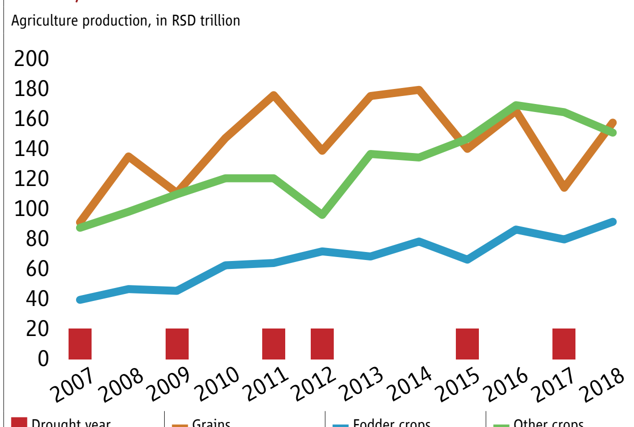
2014, subsequently adopting the NDRMP Action Plan; Disaster Risk Financing and Insurance Strategy; Guidelines for Vulnerability Assessment and Protection and Rescue Plans in Emergency Situations; and the Law on Natural and other Hazard Risk Reduction and Emergency Management.

Climate change is expected to increase the intensity and frequency of disaster events in Serbia. According to the Government of Serbia, extreme weather events in recent years have cost the country more than EUR 5 billion, with droughts and rising temperatures accounting for 70 percent of the losses.[106] Heat waves have already had an impact on the health of the population, especially in cities. Extreme heat will lead to longer dry seasons during summer period, which will reduce agricultural production and result in economic losses. By the end of the century, periods of heat waves are estimated to be prolonged to about four weeks, and the average temperature is expected to be above 35°C. Droughts are becoming more common in the Western Balkans and are one of the major climate-related risks. While climate change will reduce the number of days with precipitation in the Western Balkans by 10–20 days each year until the end of the 21st century, the intensity of precipitation will increase throughout the region.

Managing climate-related risks will require a shift from concentrating mainly on emergency response to adopting a more comprehensive approach based on resilience and risk management. This shift would require: (i) better understanding the contingent liabilities caused by adverse natural events; (ii) implementing proactive risk reduction measures; (iii) adopting policies to avoid exacerbating future risks; and (iv) developing more efficient methods to respond to disasters, such as risk financing instruments to manage liabilities. Resilience of critical infrastructure is still at risk. The energy sector may suffer the same damage caused by floods like those in 2014 if the government does not enact real change in the operation of mines and the energy supply chain. Transport infrastructure plans should include measures to protect critical infrastructure and ensure access to affected areas in case of disasters. Investing in increasing transport infrastructure resilience today is much less costly than rebuilding post disasters. Moreover, there are untapped benefits of non-infrastructure risk reduction measures such as risk-informed planning, design and building codes that consider resilience, and community engagements to increase awareness about climate and disaster risks. Serbia also needs to enhance the responsiveness of the social protection and health systems to shocks, which would require adjustments to the legal framework (including guidelines and procedures), social benefits, and service delivery.[107] Despite recent improvements to legislation and guidelines, disaster risk management is constrained by weak policy capacity and coordination (including data sharing). A coherent mechanism and institutional capacity to assess, plan for, and mitigate risks will be critical to make Serbia resilient to climate and disaster risks.

As highlighted in the 2015 SCD, agriculture is the sector most vulnerable to weather hazards and climate change. More frequent and intensive droughts in the past two decades have had a deep impact on Serbian agriculture. Droughts can reduce the average crop yield by over 40 percent, which could worsen as the climate continues to change (Figure 30). The 2017 United States Agency for International Development's Climate Change Risk Profile for Serbia projects a rise in temperature and decline in precipitation by 2050 that will affect rainfed crops, which dominate Serbian agriculture.[108] Diversification in Serbia's agriculture would be important to reduce risks through climate mitigation and improve resilience through climate adaption. Unsustainable agricultural production practices are, however, common in Serbia, particularly among

Figure 30. Agricultural Production is Affected by Droughts in Serbia, 2007–18.



Source: World Bank staff calculations based on national data.

smallholders. There is also little support or technical assistance in promoting agro-environmental practices, despite the increased threat of climate change and extreme weather events, which are expected to disproportionally affect poor rural households that often depended on agriculture for their livelihoods. Serbia's forestry sector (30 percent forest cover) is important for environmental sustainability but also vulnerable to these threats. Investments for ecological reconstruction could help to improve resilience to climate change and to strengthen the environmental services that forests provide (including natural hazard prevention).

Low use of irrigation exacerbates the agriculture sector's vulnerability to climate risks. In 2018, 46,000 ha of land were irrigated[109] in Serbia, compared to 120,000 ha that were equipped for irrigation during the Former Yugoslavia Republic period. The current level of irrigation covers less than 1.5 percent of Serbia's arable land, significantly lower than 3.0 percent in Bulgaria, 5.0 percent in Hungary, and around 30.0 percent in Italy and Greece.[110] The new irrigation strategy for 2020–2030, which is under preparation,[111] should include measures to use water more efficiently, considering Serbia's overall low water productivity.

To strengthen climate mitigation and reduce pollution, Serbia could do more to promote energy efficiency, clean energy, and efficient waste management. Serbia's carbon-intense economy calls for a strategic re-direction and broad policy reforms to support green growth, which would contribute to decarbonizing sectors with high emissions, reducing air pollution, creating economic opportunities, and supporting climate mitigation. More data and analytical work on this agenda in Serbia are needed. Serbia submitted its nationally determined contribution in 2015,[112] which identifies areas for mitigating greenhouse gas emissions and, for adaptation, lists agriculture, hydrology, forestry, human health, and biodiversity as the most vulnerable sectors. Serbia has committed to reduce its greenhouse gas emissions by 9.8 percent by 2030, compared to 1990 levels. Mitigation measures should target the energy sector since it is responsible for an estimated 80 percent of total emissions. There is also potential for mitigation in agriculture, which can be done in conjunction with adaptation efforts to strengthen the sector's climate resilience.

The energy sector's transition away from coal is critical to facilitate the transition to a low-carbon economy, address environmental challenges, and accelerate sustainable economic development. The EU's European Green Deal, presented in December 2019, commits member countries to invest in clean energy. Aligning with the Green Deal framework could become an important agenda for Serbia in the EU accession process.[113] The development of a long-term strategy moving away from lignite, combined with a comprehensive strategy of supporting coal regions in transition will be important for Serbia. In recent years, private investment in renewable energy has increased in Serbia, resulting in a ten-fold increase in the country's wind energy capacity. However, political economic challenges (e.g., strong vested interests and concern for potential social impacts) and institutional weaknesses have hampered efforts to reduce the country's heavy reliance on coal. Also, relatively low electricity prices provide little incentive to conserve energy and invest in energy efficiency. Despite some ongoing efforts to make public buildings more energy efficient, measures to boost energy efficiency in the residential sector would require a clear strategy and a dedicated and sustainable funding mechanism.[114]

Cleaner and more sustainable modes of urban transport, better management of available transport services, and more reliance on rail and waterways would also contribute to this low-carbon transition. After energy, transport is the second main contributor to greenhouse gas emissions in Serbia.[115] The majority of vehicles are older than 14 years and use diesel fuel. The motorization rate is expected to grow and further increase transport-induced emissions.[116] Government policy on emission targets and eligible vehicles is not strict, and no policy measure exists to incentivize cleaner engines (e.g., electric vehicles). Furthermore, there is no clear strategy to support a modal shift from cars to rail nor a strategy for decarbonizing transport overall. Given the dynamic nature of transport and relatively low levels of investments needed for shifting to environmentally-friendly management, transitioning to cleaner transport is a viable channel for reducing air pollution and greenhouse gas emission and creating livable cities in Serbia.[117]

Serbia will also need to manage the environmental impact of mining practices. Authorities need to modernize the country's mining policy, practices, and licensing framework to sustainably grow the mining sector, as discussed in section 2. Rules and regulations related to the environment also need to be modernized and effectively enforced. Pollution from mining activities has been and continues to be a problem in Serbia. Both past mining practices, with abandoned tailings across a number of locations (a cadaster of mining waste is under development), and the current expansion of mining activities can contribute to local air pollution. For example, air pollution in Bor in eastern Serbia has been linked to copper smelters.[118]

5. Governance and Institutions as Foundational Drivers for Serbia's Development

Good governance and efficient institutions are foundational drivers of Serbia's socio-economic development, including resilience to shocks, and an ability to address inclusion and sustainability challenges. Governance and institutions affect the adoption and effective implementation of policies across sectors, the level of public trust in the government, and the ability to attract investment. Since 2015, the country has made mixed progress in implementing institutional reforms and improving governance. Relative to the 7STEEs, Serbia's governance performance gap is 20 to 30 percentage points, with even larger gaps relative to the EU28 (Figure 31). While governance reforms are often challenging and non-linear, greater progress has been evident in these regional peers. As identified in the 2019 CEM, further progress on government effectiveness is a critical ingredient to sustaining and accelerating growth.

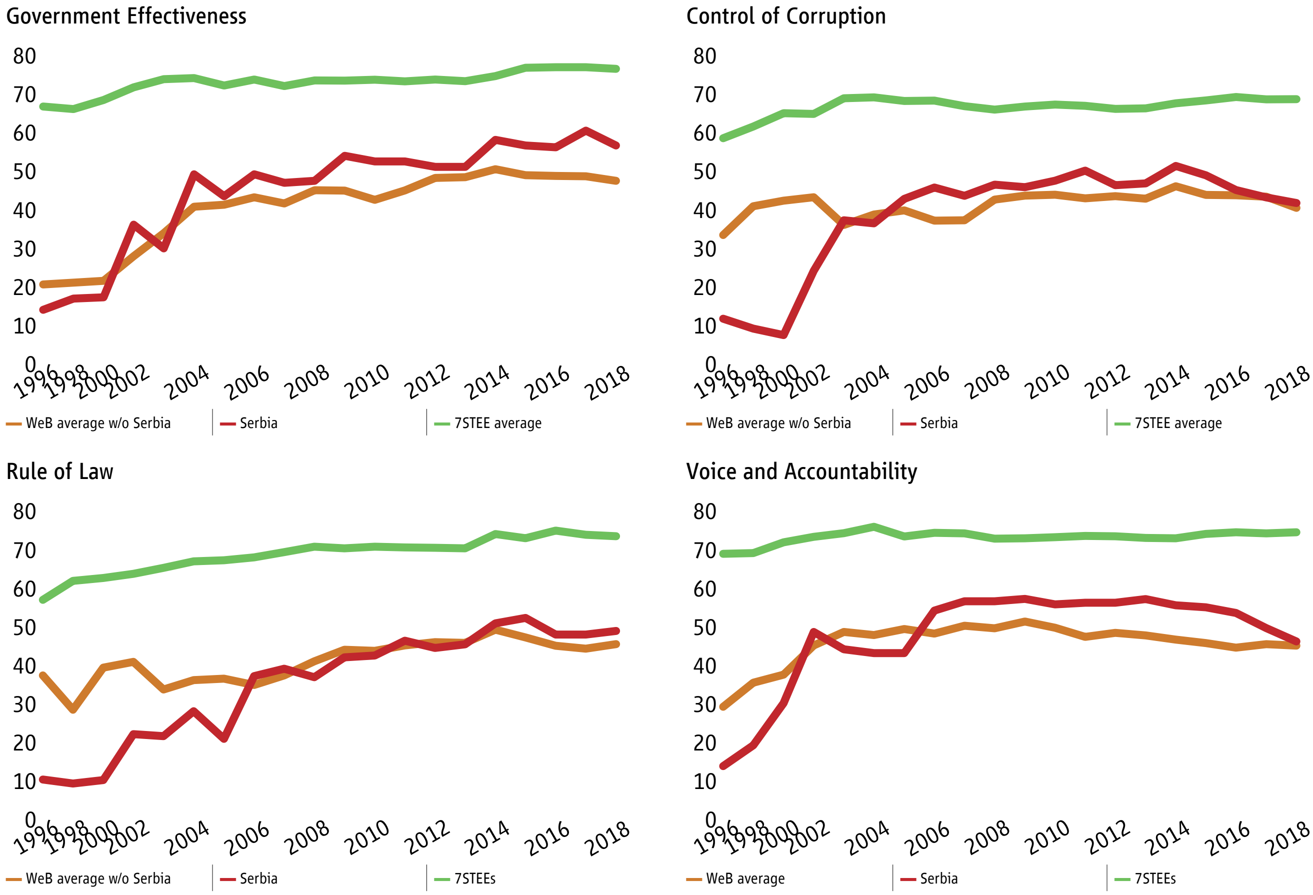
Overall Trends since 2015: Some Progress but Important Setbacks

Positive advances since 2015 have mostly included policy and regulatory changes and selected administrative innovations. Serbia adopted a new Law on the Planning System of the Republic of Serbia in 2018 as well as amendments to the law on the Civil Service and on Public Agencies, and the Government is in the process of developing a new strategy for public administration reform, including a new public financial management (PFM) strategy. The government has also started implementing e-governance and other measures to make it easier for citizens, businesses, and government agencies to interact (OECD SIGMA 2019). Overall progress made since 2015 remains uneven as reflected in key indicators (Figure 31). Across the six dimensions of governance captured by the Worldwide Governance Indicators, four have stayed flat or worsened somewhat since 2015. Two—Voice and Accountability and Control of Corruption—have seen declines of more than 9 percentage points comparing 2014 to 2018 data.[119]

Further improving institutional effectiveness and accountability will need sector specific efforts. Policy and institutional effectiveness and corruption affect social inclusion, notably in the health sector, as well as the ability to address the demographic decline (EBRD 2019).[120] Regarding environmental sustainability, discussed in section 4, there is an urgent need for further strengthening institutions and policy coherence, as well as to ensure that climate-focused policy actions are not at risk of capture.[121] Improving the business climate and addressing challenges with regard to infrastructure renewal, logistics, and transport services for citizens can be delivered more effectively and efficiently if government effectiveness and integrity are further strengthened.[122]

Figure 31. Worldwide Governance Indicators, 1996–2018.

Serbia, other Western Balkan countries, and 7STEE trends



Source: Worldwide Governance Indicators. https://info.worldbank.org/governance/wgi/.

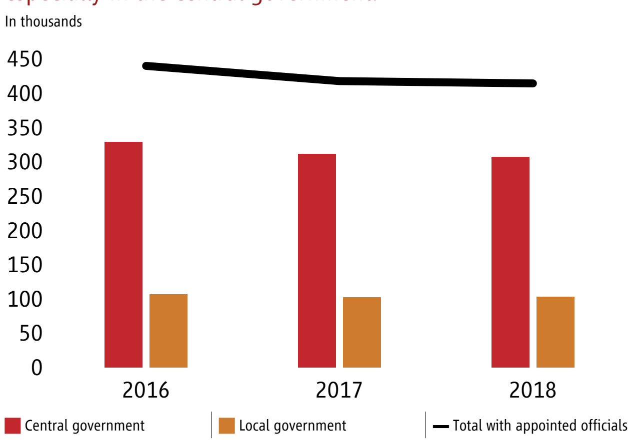
Strengthening Policy Coordination and Institutional Capacities

While the government has made efforts to better coordinate and align public policies, further progress is critical to effectively respond to economic shocks and strengthen resilience and sustainability. The main mechanisms for policy coordination include the Prime Minister's Office (PMO) and, linked to it, the Public Policy Secretariat established in 2014, the General Secretariat of the Government, as well as the Ministry for European Integration established in 2017. Additional mechanisms include four deputy prime ministers (representing the parties or factions in the coalition government), with a role to coordinate specific policy areas; the Ministry of Finance, which is responsible for the budget process; and a delivery unit team under the PMO staffed mainly by external advisers following up on the implementation of select cross-cutting initiatives (e.g., digitalization and education reforms). Relative to similar systems elsewhere, the main coordination bodies remain weak and their roles, authority and mechanisms for coordination not clearly defined. While the Law on the Planning System of the Republic of Serbia adopted in 2018 includes a hierarchy of public documents, it does not clarify the organizational hierarchy and relationships involved in creating public policies.

Parliament's role in policy debates and in exercising oversight has remained weak since the 2015 SCD. Draft laws are often not sufficiently debated in Parliament due to a wide use of emergency procedures, and the public consultation processes remain short and perfunctory. A related issue has been the practice of submitting numerous amendments by majority representatives and their subsequent withdrawal, limiting the time for substantive debate ('majority filibustering') (see also EU 2019). For a number of years, the Parliament did not discuss any of the annual reports by independent bodies in its plenary sessions, and it only approved the Laws on Final Accounts for the years 2002–2018 in December 2019.[123] There has been less use of emergency procedures since requirements were strengthened in July 2019[124] and reforms in September 2019 made it less likely for the majority party to filibuster. Establishing parliament's role in debating proposed laws is an important element of enabling citizens and businesses to become aware of and to voice inputs or concerns regarding proposed new legislation.

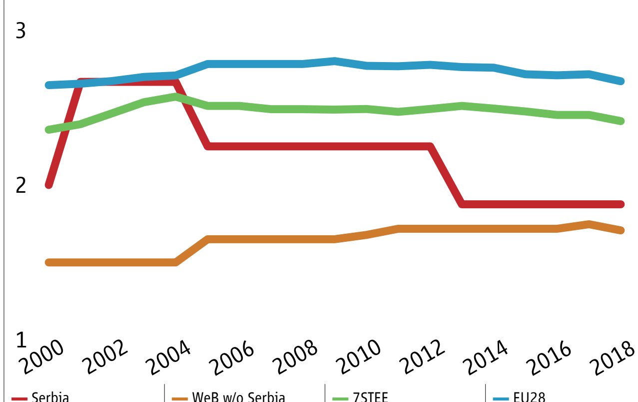
Public sector staffing and management—both at senior and at technical levels—need to be reconsidered to support government effectiveness. The practice of widely changing senior civil servants following changes in Government, and the frequent use of acting appointments, reaching over 50 percent of senior civil servants in early 2019 (out of a total of 377 positions) challenge government effectiveness. Selection processes for acting positions are weaker than for regular positions, and the practice reduces incentives for investing in long-term performance. While amendments to the Civil Service Law seek to limit the use of acting appointments, full compliance remains to be achieved.[125] At the professional and technical level, austerity measures have limited new hiring, including to replace departing staff, leading to a decline in numbers (Figure 32) and staff retention problems have emerged for areas with private sector competition for skills. Moreover, politicization has affected decisions on recruitment and promotion at the national and subnational government level and according to Varieties of Democracy data, merit-based appointments have declined significantly since the mid-2000s (Figure 33).

Figure 32. There has been a reduction of public-sector staff, especially in the central government.



Source: World Bank based on Government of Serbia data.

Figure 33. Merit-based appointments in the public sector have declined in Serbia since the mid-2000s.



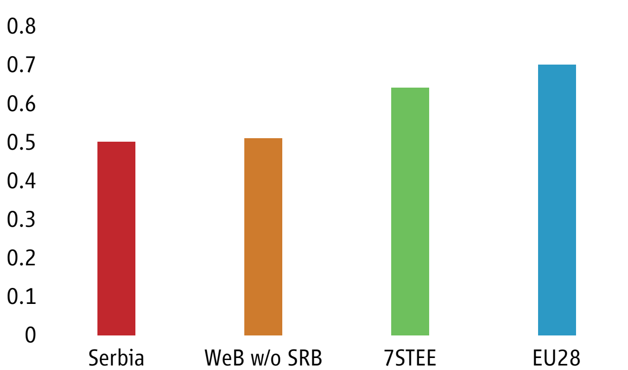
Note: On a scale from 0 (least merit based) to 4 (fully merit based).
Source: Varieties of Democracy (V-Dem).

Further improving the efficiency of the public administration and service delivery is important to deliver quality services at a fiscally affordable cost, as well as to contribute to improving the business environment. Some efficiency progress was made since the 2015 SCD through initial digitalization and the introduction of e-services, and as staff numbers declined due to a hiring freeze, and the goal to increase efficiency was endorsed through the 2015–20 Public Administration Reform Strategy.[126] With assistance from the EU and development partners, some progress has been made in streamlining government functions.[127] However, greater progress is needed if Serbia is to achieve improvements in service delivery without re-increasing wage costs to unstainable levels as employment caps are lifted. While staff in many functions are already stretched, improvements in systems and processes, strengthening IT and other tools, and a willingness to re-allocate capacities from declining to growing functions are important.[128]

PFM reforms have seen important progress, with a focus on better controls in support of maintaining fiscal discipline but less progress on using budgets strategically in support of sector reforms.[129] Public budgets have been overall reliable, with deviations within manageable levels. Important progress has been made in the area of commitment control and management of arrears at the national level through the introduction of a system linked to the Budget Execution System that allows vendors to register their invoices. Authorities have continued to strengthen public internal financial control as well as external audits. However, there has been a limited impact from measures to make budgets more strategic by establishing program objectives and targets and adopting medium-term plans. Budgets still lack greater transparency, as reflected in Serbia's rating of 43 out of 100 on the Open Budget Index in 2017 and 2019. The government is currently preparing a new PFM Reform Program for 2021–2025, and it is planning a new public expenditure and financial accountability assessment to evaluate progress made since 2015.[130]

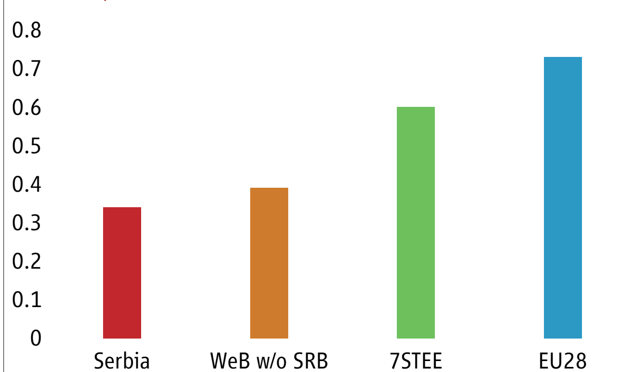
Serbia's justice system has seen some improvements in efficiency in recent years, but the backlog of cases is still high, and judicial independence is an issue. According to a 2018 report from the European Commission for the Efficiency of Justice, it takes 320 days to resolve a civil or commercial case in a first instance court in Serbia, well above the EU average of 233 days. Also, the country's first instance courts have a negative clearance rate for civil and commercial litigious cases, which means that they process fewer cases than they receive, increasing the backlog. Stabilizing the legal framework and ensuring that laws and regulations are clear, including those pertaining to property rights and other aspects, could contribute to easing the burden on courts and contribute to improvements for citizens and businesses. In addition, there are concerns regarding the transparency, accountability, integrity and independence of the judiciary (Figure 34).[131] The justice system is rated as less free from government interference in Serbia than in the 7STEE and the EU28 (Figure 35).

Figure 34. Composite index of the quality and independence of civil justice.



Note: No data available for Ireland, Latvia, Lithuania, Luxemburg, Montenegro, Kosovo, and Slovakia.
Source: WJP Rule of Law Index.

Figure 35. The civil justice system is rated as less free from government influence in Serbia than in other Western Balkan countries, the 7STEE and the EU.



Note: No data available for Ireland, Latvia, Lithuania, Luxemburg, Montenegro, Kosovo, and Slovakia.
Source: WJP Rule of Law Index.

Sub-national institutional and fiscal capacity needs to be strengthened to enhance livability and competitiveness in urban and rural areas. Public investments at local levels have been very low compared to CEE countries, due to limited fiscal allocations and local revenue capacity, as well as large expenditures on operational costs, subsidies and servicing debts.[132] Local public enterprises constitute a major challenge as they require subsidies just to cover operating losses, while most would need to make major new investments for improving transport, water and sewage and waste management services. Further challenges include the need to fully clarify roles and mandates of the different levels of Government, and to invest in modernization and staff training at sub-national levels. The latter process has been initiated, led by the National Academy of Public Administration (NAPA), with support from various development partners.[133]

Controlling Corruption and Rent-seeking, and Strengthening Transparency and Accountability

Perceptions of corruption have gradually worsened compared to 2015. According to Transparency International's 2019 Corruption Perception Index, Serbia ranked 91st out of 180 countries, with an average score of 39 out of 100, and the Worldwide Governance Indicators (Figure 31) show a gradually declining trend. The EC also noted in 2019 that "there is a need for strong political will to effectively address corruption issues, as well as a robust criminal justice response to high level corruption."[134] Previous corruption prevention reforms in Serbia have yielded limited results. Rent seeking—the practice of manipulating public policy to increase profits for a select group—has an impact on the business environment, public spending, and local socio-economic development. In Serbia, areas of concern include: (i) SOE governance, including through the use of acting appointments, which can create a weak control environment (see Section 2); (ii) government contracting at national and sub-national levels (with specific concerns raised about the implementation of large-scale projects without competitive public tenders, e.g., through inter-governmental agreements, arms exporting deals, contracts and subsidies for small hydropower plants, etc.); (iii) differential use of regulatory powers to hinder business growth of non-aligned entrepreneurs; and (iv) the allocation of state-owned land for non-designated purposes (e.g., for construction on agricultural land).[135] Corruption and rent-seeking negatively affect the business environment, especially for domestic investors,[136] as well as efforts to promote inclusion and environmental sustainability—for example, due to corruption risks in the health sector or with regard to waste management and environmental inspections.

Public investments and procurements are the government expenditures most prone to corrupt practices. The level of competition in the public procurement process remains limited. The average number of bids per tender fell from 3.0 in 2017 to 2.5 in 2018, the lowest level in the last five years. Competition is even lower at the local level: there was an average 2.1 bids for tenders published by local public administrations in 2018. A new decree on public investment management and a new procurement law were adopted in 2019 intending to provide better rules for selecting and preparing projects (with important exceptions as noted above), and a basis for more open and competitive procurement.

Expanding transparency and accountability are important to limit opportunities for corruption and rent-seeking. Further improving transparency, for example about public procurement processes, the operation and performance of SOEs, and realizing commitments to strengthened consultations, can help in this regard. Reversing the decline in media freedom is also important, as Serbia's ranking on the Press Freedom Index dropped from 64th out of 173 countries in 2008 (score of 13.5) to 90th out of 180 in 2019 (31.2) in 2019, and performance on voice and accountability in the WGI has also worsened in recent years (Figure 31).[137] Limited accountability reduces the likelihood that authorities and the public can identify and effectively address corrupt practices.

Significant Socio-Political Risks

The unresolved relationship with Kosovo poses a significant socio-political risk. In 2018–19, the relationship between Serbia and Kosovo worsened. After Kosovo imposed tariffs of 100 percent in November 2018 on all imports from Serbia (about EUR 400 million in the preceding year), the EU-mediated dialogue between Kosovo and Serbia was suspended. Seeking to unblock the situation, the United States appointed a new special envoy to the Western Balkans and a dedicated special envoy for Serbia and Kosovo in the fall of 2019, signaling renewed attention to improving the relationship.

In its external relations, Serbia is seeking to balance building relations with several partners—China, the European Union and Russia, as well as the US and others—which entails some risks and tensions. Chinese investments in Serbia have increased in recent years in mining, manufacturing, and transport, and Serbia is a part of China's Belt and Road Initiative. The EU is Serbia's main trading partner, especially in terms of exports, and its largest source of foreign investments. The ongoing EU accession process involves regulatory convergence as well as significant pre-accession assistance. Also, the United States re-intensified its engagement with the Western Balkans in recent years. The Russian Federation is a major trade partner, mainly in terms of imports, and has intensified its relationship with Serbia in recent years, including regarding Kosovo-Serbia relations. In addition, Serbia's bilateral debt has been shifting towards the United Arab Emirates since the 2015 SCD, with the latter now accounting for 45 percent of bilateral debts, up from 35 percent five years ago.[138] As a small open economy, Serbia needs to ensure that its foreign relationships serve its long-term goals and minimize any associated corruption or environmental risks, e.g., from foreign partners seeking to apply lower standards.

Serbia is part of major drug trafficking routes, and organized crime linked to illicit activities pose a further risk. As is highlighted by the World Bank's 2011 World Development Report, external negative influences can pose challenges and risks. In its 2019 assessment, the EU noted that progress has been made in terms of adopting a new legal instrument in 2018 (Law on organization and jurisdiction of state authorities in the fight against organized crime, terrorism and corruption), but effective investigations and prosecution of cases remain rare.[139]

Finally, increased political polarization and reduced competitiveness constitute another major socio-political risk. Political competitiveness in Serbia has declined and polarization has increased since the 2015 SCD. According to the WGI, Serbia's rating on political stability declined from the 55th to the 50th percentile between 2014 and 2018 and it remains about 20 percentiles lower than in the 7STEEs. According to Freedom House, the country's rating on national democratic governance declined from 3.75 in 2015 to 4.5 in 2018, and the rating for independent media declined from 4.25 to 4.75 in the same period.[140] In its 2019 assessment report, the EU notes a "polarized political scene" in Serbia.[141] A perception of reduced competitiveness has triggered protests in the country, a boycott of parliamentary sessions by fifty-five out of eighty-eight opposition members of parliament, and announcements by opposition parties in September 2019 that they intend to boycott the 2020 elections. As of January 2020, the potential boycott of the elections remained unresolved despite EU mediation efforts. The incumbent coalition also governs in more than 90 percent of municipalities, which is unusual in competitive democracies.[142] The unresolved relationship with Kosovo and disagreements about the conditions for elections tend to absorb Serbia's political attention and efforts. From a growth and inclusion perspective, voter attention to economic, social, and service delivery performance of a government is important to create incentives for strong efforts in these directions.

6. Priorities

The SCD Update revisits the priority areas for Serbia today, based on the latest developments and analysis of constraints discussed earlier. Serbia has come out of economic stagnation and resumed poverty reduction since the first SCD. However, many of the same constraints are still hindering faster progress on shared prosperity and convergence with the EU, with inclusion, environmental sustainability, and resilience becoming more salient challenges than during the fiscal stress in 2014. Table 1 summarizes the evolution of the key issues identified in the first SCD. Prioritization in the SCD Update is based on similar criteria to the exercise in the 2015 SCD: impact on the goals of sustained poverty reduction and shared prosperity, complementarities (how impact can materialize through multiple channels), and time horizon of the impact (balancing immediate results with impact in the longer term). Prioritization is also informed by new knowledge from recent analytical work (see Annex 2 for new knowledge and an update of key data and knowledge gaps) as well as internal and external consultations.

Table 1. Evolution of Key Issues Identified in the 2015 SCD

2015 SCD: Main findings	How these issues have evolved since
• Average annual growth around zero in 2009–2014, down from 5 percent in 2000–2008.	• GDP growth 3% (annualized 2015–2019).
• Progress in poverty reduction partly reversed after the crisis, bottom 40's consumption fell by 3.8 percent (annualized). To make progress on poverty reduction and shared prosperity, Serbia needs a growing and inclusive economy.	• Poverty declined, bottom 40's income increased by 3 percent (annualized 2013–2016).

• Pre-crisis consumption-fueled growth was unsustainable. Higher investment, productivity, and exports will contribute to more balanced and sustainable growth.	• Serbia still needs higher investment, productivity, and exports to drive faster growth:
	  • Recent growth driven by investment and consumption, but investment still low
	  • Exports have increased, but outpaced by imports
	  • Increasing labor-intensive FDI attracted by subsidies, but with low value added
	  • Productivity growth not enough to boost stronger GDP growth.

• Serbia needs to restore fiscal sustainability, improve governance and institutional capacity, complete SOE reforms and reduce the state's footprint, make business climate more attractive, and remove infrastructure constraints to productivity and competitiveness.	• Fiscal situation improved: surplus in 2017 and 2018, debt down to 52% of GDP—but renewed risks. • Governance and institutions: select improvements, but new and continuing problems which remain as the underlying constraint holding back progress across areas. • Some improvements in business environment, but deeper issues related to governance and market structure. State presence still large in the economy. Several commercial SOEs privatized; remaining SOEs esp. utilities. • Infrastructure: some road investments completed, but logistics performance still weak; more is needed to remove digital infrastructure constraints.
• Serbia runs the risk of losing another generation of workers with many inactive, unemployed, or working informally. Addressing labor market issues is critical.	• Employment has recovered to just surpass pre-crisis level, but structural issues remain with still high inactivity, unemployment, informality, and disparities across groups. • Skills gaps are increasingly an issue for business.

Table 1. Evolution of Key Issues Identified in the 2015 SCD (continued)	
2015 SCD: Main findings	How these issues have evolved since
• Improving agriculture productivity and equitable and quality services will help raise welfare in rural areas and among disadvantaged populations.	• Agriculture productivity has been rising slowly and remains low and regionally highly uneven. • Equity and efficiency of service delivery has largely remained a problem, despite some improvement.
• Serbia is exposed to environmental/climate and social/political risks that need to be managed.	• Environmental and climate-related risks remain (e.g., 2015 and 2017 droughts led to decline in agriculture output, high CO2 emissions). • Social/political risks relate to increased political division and monopolization and the continued need to deliver tangible results to maintain support for reforms.

The SCD Update argues for a two-tone agenda: (i) continuing the necessary second-generation reforms in some priority areas and (ii) elevating emphasis in other areas compared to the previous SCD. The Update identifies 8 priority areas, shown in Table 2. The first group of priorities implies that Serbia needs to continue efforts in sustaining macroeconomic stability, fostering private sector dynamism, and strengthening governance and institutions. The second group of priorities places increasing prominence on promoting inclusion, environmental sustainability, and resilience through: building equitable human capital, reducing labor market barriers, addressing the challenges of lagging regions, addressing immediate environmental challenges, and strengthening climate resilience and supporting a low-carbon transition. These challenges were important before but received less attention in the first SCD because the overwhelming urgency back then was to restore economic stability. All of the eight priorities have direct impacts on more than one area of the SCD Update's framework: growth, inclusion, environmental sustainability and climate resilience, and governance.

Table 2. Summary of priority areas	
Priority areas where continued efforts are needed	Priority areas with increasing prominence
• Sustaining macroeconomic stability • Fostering competitive markets and enhancing the business environment • Strengthening government effectiveness, efficiency, and accountability	• Building relevant skills and providing equitable opportunities for acquiring human capital • Reducing labor market barriers and work disincentives • Addressing the challenges of rural areas and lagging regions • Addressing immediate environmental challenges to protect quality of life • Strengthening climate resilience and supporting a low-carbon transition

The Update's priority areas are broadly similar to those identified in the 2015 SCD, with a few adjustments. The main changes are:

- The 2015 SCD presented three tiers—foundational, highest impact, and supporting priorities—to capture the urgent issues then for restoring growth and protecting the less well-off. Now that Serbia has restored economic stability, actions to tackle the most critical constraints for growth, inclusion, and environmental sustainability become equally important top priorities. Thus, the Update does not retain the three tiers.

- Some priority areas receive more prominence: The 2015 SCD presented water, sanitation, and environmental sustainability as a supporting priority. The SCD Update considers these as part of more comprehensive priorities to address environmental challenges and climate actions, given their impact on livelihoods and sustainable economic development. In addition, the skills constraint has increased significantly as a priority, as noted earlier in this Update.

- In some areas, the focus has shifted: The nature of the macroeconomic stability priority changed from restoring to sustaining this stability. Transport infrastructure is not considered a separate priority as in the 2015 SCD, given significant investments since, but regional transport connectivity and sustainability are emphasized to support inclusion and resilience. Supporting higher agricultural productivity and rural income was a priority for inclusion and poverty reduction in the 2015 SCD. To address spatial inequality, the Update broadens the focus into a priority on tackling the challenges of rural areas and lagging regions.

Priority areas where continued efforts are needed

Sustaining macroeconomic stability: Despite improvements since the 2015 SCD, efforts to sustain Serbia's hard-won macroeconomic stability will be critical given continuing and new risks, related to higher domestic spending pressures, a need to increase public investments, as well as to risks from potential new external shocks (including effects of a shock on NPL levels). The government's debt level, though reduced, is still higher than in 2009. Any significant decline in stability could lead to a renewed period of low or negative growth and associated impacts on inclusion. A global slowdown—considering potential impacts of the current COVID19 outbreak in the world—could hurt Serbia's exports, FDI, remittances, and bank lending to the private sector. Fiscal buffers are essential to allow for potential policy responses in Serbia to address the outbreak. The emerging health and economic risks from this virus outbreak further underscore the need for Serbia to safeguard macroeconomic stability and strengthen resilience.

Fostering competitive markets and enhancing the business environment. Critical proximate factors for faster growth are to enable accelerated productivity growth across business sectors, to continue expanding public investments and FDI, encouraging a move to higher-value adding activities for the latter, and creating a more enabling environment for domestic private investments, including the constraints faced by SMEs. Important policy efforts include enhancing government effectiveness and transparency across relevant institutions and levels of government, regulatory quality and transparency (including further streamlining, as well as attention to property, land, logistics and trade regulations in particular) and reducing competition barriers (including public company advantages and overall SOE governance) and developing the financial sector, while maintaining appropriate monitoring and oversight. Enabling innovation and technology adoption is important for enhancing firms' productivity and goes hand-in-hand with skills development (priority below on human capital).

Strengthening government effectiveness, efficiency, and accountability: Government effectiveness, efficiency, and accountability are critical constraints to overall development, including stronger and sustained growth, inclusion, and environmental sustainability; and there are also important links to managing demographic change and EU accession. Improvement since the 2015 SCD has been limited and uneven, with stronger efforts needed across levels of government. Serbia needs to improve policy coherence, public investment management (PIM), public sector efficiency and further modernization, SOE governance and regulation; strengthen transparency, accountability, and rule of law; and improve sub-national institutions, enabling dynamic cities and well governed towns and communities. Digitalization can be a useful tool for enhancing government effectiveness, efficiency, and accountability, and it needs to be matched by efforts to reduce risks of state capture and corruption and to establish a clear focus on achieving results and merit-based management. Improvements in these areas will have significant positive impacts on the business environment, service delivery, and enabling policy actions and investments to address environmental challenges.

Priority areas with increasing prominence

Building relevant skills and providing equitable opportunities for acquiring human capital (education, health, social assistance): Skill gaps are increasingly a constraint to doing business, compared to several years ago. Building relevant skills will contribute to higher growth and better jobs, and more productive workers will be necessary to counter the adverse impact of Serbia's aging and declining population. Serbia needs to address long-standing constraints in education and training to expand early childhood education; modernize the curriculum; streamline and enhance the relevance of VET; strengthen relevance, accountability and quality assurance in higher education; and improve lifelong learning opportunities. In addition, more equitable access to quality education and healthcare remains critical for closing gaps and reducing inequality so that the poor and disadvantaged groups in Serbia can prepare themselves and have a better chance in the labor market. The high out-of-pocket payment for health expenses limits affordability for these groups to access services, in addition to a high NCD burden and weak efficiency in health service delivery. The current COVID-19 outbreak further illustrates the importance of health sector efficiency and preparedness. Inclusion of the Roma population would require continued efforts to address the multiple barriers they face. The recent research on Roma exclusion in the Western Balkans recommends an integrated approach—through service provision, social benefits, and focused interventions—in five policy areas: education, labor market, health, housing and access to essential services, and documentation.[143] Increasing the coverage of financial social assistance will also help protect basic livelihoods and investment in human capital among the poor and vulnerable.

Reducing labor market barriers and work disincentives: More than 40 percent of people aged 15–64 in Serbia are not working or searching for a job, despite recent improvements in employment and labor force participation rates. As highlighted in the 2015 SCD, reducing the high labor tax and contribution burden (particularly for low-wage, low-skill workers and those with dependents), strengthening the effectiveness of job matching through improved employment services, and improving labor market activation in the design and implementation of social assistance remain important to lower disincentives and barriers to work, including for disadvantaged groups. Promoting women's access to economic opportunities—through improved child-care access and reforming labor tax and regulation, for example—can help narrow the 13.7-percentage point gender gap in employment rates and bring more workers into the declining workforce. The demographic challenges underscore the critical need to use all of Serbia's available workers effectively.

Addressing the challenges of rural areas and lagging regions: Similar to the 2015 SCD, supporting rural income through enhancing agricultural productivity and non-farm activities remains important for poverty reduction and inclusion. Moreover, addressing specific challenges of Serbia's lagging regions (low-income and low-growth regions) and local connectivity is increasingly important to reduce spatial inequality, manage the negative impacts of declining populations in those regions, and promote inclusion. Equitable provision of basic services, including health and education as discussed above, is critical to ensure equal opportunities for all citizens regardless of where they are born. Improving local transport connectivity (including public transport) would help to facilitate mobility, market access, access to education, and job opportunities. For those lagging regions with growth potential (depending on their economic geography characteristics and sectoral comparative advantage), strengthening the enabling environment for business and good local governance would help to promote economic opportunities and attract and retain young people. Serbia's potential for sustainable new mining, if well-managed, can also offer economic opportunities in those remote areas.

Addressing immediate environmental challenges to protect quality of life: Environmental threats such as poor air quality and wastewater treatment in Serbia seriously affect health, quality of life, and the economy. Serbia urgently needs to control and reduce air pollution, the main sources of which come from energy, transport, and industry. Putting in place effective mechanisms for air quality management is needed across many Serbian cities. Strengthening water quality and wastewater treatment to address the current health hazards relies on addressing the underlying investment needs, institutional capacity, and accountability in enforcing environmental standards. Addressing these immediate environmental hazards would also help make Serbian cities and towns more livable and more competitive, contributing further to growth and inclusion.

Strengthening climate resilience and supporting a low-carbon transition: Serbia remains prone to weather hazards such as droughts and floods. Despite recent improvements in legislations and guidelines related to disaster risk management, a more comprehensive risk management approach remains important to strengthen climate resilience. This approach would include strengthening policy coordination (including data sharing), capacity, more comprehensive risk reduction through infrastructure and non-structural measures (e.g., risk-informed planning, building codes, and awareness raising), enhanced resilience in energy and transport infrastructure and responsiveness of the health sector, and more adaptive social protection programs. To help mitigate climate change and reduce environmental hazards (as those discussed in the above priority on the environment) in the future, Serbia needs better management and cleaner use of resources. This would require tackling the investment and institutional constraints to transitioning toward higher energy efficiency and cleaner energy, transport (e.g., multimodal transport connectivity), agricultural practices, as well as non-coal mining. Transitioning to low-carbon, greener growth is increasingly emphasized given Serbia's path toward EU accession, following the launch of the European Green Deal in 2019.

The SCD Update also revisits the key data and knowledge gaps. Key gaps include data and knowledge in the following areas: strengthening environmental sustainability and transition to green growth; migration profiles, drivers, and impacts; tax reform options and progressivity of fiscal policy; drivers of out-of-pocket health payments and private provision; drivers of economic mobility and effective interventions to promote inclusion of disadvantaged groups and regions; select business environment issues such as spatial management; drivers of policy and government effectiveness, including at subnational levels. Annex 2 provides further details of the recent knowledge and analytical work as well as updated data and knowledge gaps.

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Annex 1: Comparison with priorities in the 2015 SCD

Table A.1. Comparison with priorities in 2015 SCD

Priorities in the SCD Update	Priorities in the 2015 SCD (approximate matching)
Sustaining macroeconomic stability	Fiscal sustainability, financial and macro stability: Restore debt sustainability and maintain macro and financial stability.
Fostering competitive markets and enhancing the business environment	SOE reform: Reduce the state's footprint in the economy and make the public sector more efficient by privatizing commercially oriented enterprises, restructuring large public utilities, and rightsizing the public sector. Business climate reform: Create an environment conductive to private sector-led investment, growth, and job creation. Infrastructure: Enhance the quality of public infrastructure to better support international, regional and domestic connectivity.
Strengthening government effectiveness, efficiency, and accountability	Governance and institutional capacity: Create an effective institutional mechanism within government to coordinate, implement, and monitor reforms.
Building relevant skills and providing equitable opportunities for acquiring human capital	Education and skills: Expand access to and the quality of education for all, in particular marginalized groups; increase workforce productivity by improving skills and learning outcomes Health: Expand access to care for marginalized groups, reduce disparities and improve the quality of care and health outcomes, and reduce the fiscal risks related to personal spending on health. Social protection: Improve the coverage, equity, efficiency, and fiscal sustainability of pensions and the social assistance program.
Reducing labor market barriers and work disincentives	Labor market institutions: Strengthen these institutions to facilitate formal employment, create earnings opportunities for the less well-off, and help mitigate the negative consequences of SOE reforms.
Addressing challenges of rural areas and lagging regions	Agriculture, self-employment: Support higher agricultural productivity and rural incomes to improve the welfare of the B40 and reduce poverty.
Addressing immediate environmental challenges to protect quality of life	Water and sanitation: Enhance Serbia's water resource management, wastewater treatment, and environmental sustainability
Strengthening climate resilience and support a low-carbon transition	Additional emphasis on managing weather risks and climate change

Annex 2: Knowledge and data gaps

Several knowledge gaps identified in the 2015 SCD have been filled, through country specific as well as regional studies. Labor demand, firm competitiveness, and job creation dynamics have been examined in a new CEM (2019), productivity diagnostic (2019), private sector development policy note (2019), forthcoming jobs and competitiveness report, and small-medium enterprise competitiveness programs PER (2019), among other. On the labor supply side, a number of recent studies have filled knowledge gaps on skills, including STEP skills reports (2015, 2018) and a skills policy note (2019). A series of functional reviews, completed in 2016 and 2017, shed light on the organization and core functions of several ministries and sectors, including Finance, Justice, and Health, as well as on cross-cutting challenges and opportunities for streamlining. A diagnostic on Public Investment Management was delivered in 2019, as well as a regional survey of how companies perceive the justice sector's impact on the business environment.

Trends in agricultural sector productivity and spending efficiency were explained in the agricultural policy note (2018), and studies on doing business in agriculture (2019), agribusiness value chains (2018), and agriculture sector potential in Western Balkans (2018), as well as a dedicated agriculture sector PER (2019). A school network study (2017) and a higher education policy note (2018) addressed some of the knowledge gaps on education infrastructure. Studies on Roma inclusion in the Western Balkans (2019) and Roma returnees (2019) generated new insights on that minority and its needs. A study on the socio-economic dimensions of LGBTI exclusion was also completed in 2019.

A mining sector diagnostic (2019) and renewable energy integration assessment (2017) shed new light on the extractive sector and renewables market. And disaster risk and climate vulnerability, a vital new policy priority, was carefully explained in a DRM finance country note (2016) and country climate brief (2016). Other additional knowledge includes new and more detailed evidence on SOE sector monitoring systems, public financial reporting, lagging regions, urbanization, transport and digital (broadband) connectivity, water sector, and gender policy and women's access to economic opportunities.

This SCD update identifies the following key knowledge gaps in Serbia. Continuing to fill these gaps would strengthen the knowledge base to understand the key priorities and help identify policy actions to address these constraints.

- Migration patterns and drivers both within and outside the country remain poorly understood, partly due to a lack of data (e.g., migration and the profiles and behavior of migrants).

- Reform options to address labor tax and more broadly improve progressivity of fiscal policy: while previous analyses have pointed out the inefficiencies of current social security contributions policy and need to reform labor tax, potential reform options and fiscal costs have not been investigated as closely. More broadly, comprehensive analysis distributional impacts of fiscal policy would inform reform options on both the tax and expenditure sides.

- Better understanding of the drivers of economic mobility and effective interventions to promote inclusion of certain groups (e.g., Roma population) and reduce spatial inequality while supporting economic growth.

- Drivers of rising out-of-pocket payments, with more disaggregated data, and volume, cost and quality of services delivered by private health care providers in Serbia.

- Better understanding of deeper business environment issues—e.g., considering in detail key remaining business environment constraints, especially sector-specific licenses and permits, spatial/land-management and property

SERBIA SYSTEMATIC COUNTRY DIAGNOSTIC UPDATE