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Private Sector Development and Business Enabling Environment Assessment April 29- May 12, 2009

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Executive Summary

Private sector development and workforce development, including worker social protection, coupled with rationale, reliable, and equitable laws are critical to the sustainable development of Serbia's economy and the country's regional and global integration. The 2008 elected government, albeit fragile due to a patchwork quilt-type political coalition, seems poised to embrace European Union integration and move the country towards a 21st century market economy. For the last ten years, however, Serbia did not make the political and economic advances that many of its neighbors did.

Serbia has been slow out of the political and economic reform starting gate. While several of its neighbors moved fairly quickly to reform their political and economic landscapes after the fall of communism in 1998 and to join the EU, Serbia did not. Instead, Serbia looked backwards, or perhaps it was just frozen in its tracks, and did little to incorporate 21st century efficiencies in government administration, business, education, or trade

With the assistance of USAID and others, Serbia in 2001 slowly began to introduce legal and regulatory, financial sector, labor market, and macroeconomic reforms. Several new laws and measures have been introduced to address the huge inefficiencies in how the government and businesses operate. The successes to date, however, are not sufficient to promote sustained economic growth and political and social stability even if the current global financial crisis were not a factor. Unemployment is high, the informal economy is large, and the sizeable budget expenditures crowd out private sector growth and development. According to the OECD, employment declined in every year from 2001 through 2006, with a slight recovery in 2007. With the global economic crisis, Serbia's unemployment rate this year is expected to rise over 18%.

Businesses and economic experts point out that Serbia must reform its tax, pension, trade, and real estate structures if meaningful and sustainable economic growth is to be achieved. They also decry the weak education and legal systems that are making Serbia less attractive to foreign direct investments and domestic business expansion.

Serbia's pension reform, which began in 2001, is not finished. Total pension expenditures are 25% of the total government budget, about 5.5% of GDP. Without question, the pension system is unsustainable and needs to be reformed in keeping with a national strategy that addresses old-age security over the long-term. The voluntary pension system is nascent, which some view as having too little traction to address pension adequacy for future retirees. It should be developed and expanded to help citizens save for their retirement as part of the overall old-age security structure in Serbia.

These factors in combination make a compelling case for USAID/Serbia to remain firmly engaged in Serbia. USAID/Serbia is uniquely qualified to help Serbia continue to transition from a planned economy to a modern, regionally, and internationally integrated market economy. Such a transition, unquestionably, takes time and cannot be achieved fully in a few short years. As such, what Serbia now needs is "Next Phase", and in some cases, "FINAL Phase" technical assistance from the donor community to ensure durable economic growth, private sector development, and political stability.

USAID/Serbia's investment in Serbia, thus far, has been substantial. Unmistakably, it is that very reason why a few more years of economic growth and private sector development with a keen focus on workforce development are necessary to enable Serbia to cross the bridge to a well-regulated, effective, and efficient 21st century market economy sooner than later. What we don't want to do is to withdraw our macroeconomic and private sector development technical assistance too early and have Serbia lose the momentum we have helped them build or undermine the successes the country has achieved to date.

Methodology

This assessment, the first of a likely two-part assessment, is a review and analysis of the private sector development and business-enabling environment in Serbia. This particular assessment concentrates on Serbia's labor market and workforce environment and its social protection system, primarily the pension system, as it relates to private sector development and the business-enabling environment.

For a complete picture of private sector development and the business-enabling environment in Serbia, part two of this assessment will need to address the following areas: infrastructure, financial sector development, real estate (land titling, ownership/restitution, construction, and financing), business registration, tax administration, intellectual property and competition law.

The Part 1 assessment was conducted by Denise Lamaute, USAID/Washington, a labor market and social protection specialist in the Europe and Eurasia Bureau. The team, which also consisted of colleagues from USAID/Serbia's Economic Growth Office – Jim Stein and Walter Doetsch - took an informal, information-gathering approach to interviews with key informants. Guided in part by the Mission's questions (including the question, what if USAID/Serbia doesn't continue with this activity or aspects of it?) and supplemented by our own, we sought to understand firsthand the interviewees' perspectives on Serbia's economy, the changes and prospects in current times and the future, its financial sector, mainly the pension system, and the macro and legal and regulatory environment that influences foreign direct investments, business expansion, and job creation.

This assessment employed both primary and secondary data and a mix of research methods for the study. The primary data sources included face-to-face interviews during the period of April 29 – May 12, 2009 as well as the collection of reports and data via e-mail. We interviewed firms, government agencies, non-governmental organizations, and other members of the international donor community.

We asked for recommendations on ways in which relatively modest funds might make the most significant contribution for sustainable economic growth a private sector development in Serbia. We asked about strategies for developing a modern workforce, where new job opportunities might be created, and where policies and capacities needed to be developed to improve the business climate. We asked questions, probed, listened, made site visits to observe programs and agencies first-hand, and enjoyed in lively conversations with a host of Serbian professionals.

By the middle of the second week, clear themes were emerging, and these themes guided the direction for most of our interviews during the balance of the assessment period, and have formed the basis for the recommendations, thus far. These recommendations may be revised once paired with Part 2 of this private sector development and business enabling environment assessment.

While this analytical process was rigorous and scrupulous, our intention is that the tone of this assessment and its recommendations will be action-oriented, rather than academic. We received many suggestions for possible USAID assistance, and present priority options in the context of taking steps to develop a comprehensive economic growth and private sector development system. We propose a strategy that begins with *system-building,* and includes *institutional and human resource capacity-building.*

We have narrowed the suggestions to four actionable recommendations that build on USAID/Serbia's work thus far in the area of economic growth and macroeconomic stability. The recommendations complement USAID/Serbia's other project areas, as well. The recommendations are - assist the government of Serbia (GOS):

1. Harmonize the financial and business legal and regulatory environment, including administration and enforcement, with EU laws and standards[1];

[1] In April 2008, Serbia entered into the Stabilization and Accession Agreement with the European

2. Develop a national strategy and action plan to address business expansion, job creation, and a workforce trained and capable of making a significant contribution to increasing productivity and profitability, and ultimately increased economic growth;
3. Develop a national pension reform strategy that addresses the long-term fiscal stability and sustainable of the pension system; and
4. Assist Serbia access any and all EU pre-candidate accession funds far greater than any other recent EU country has done to date and to leverage and enhance Serbia's bilateral support, in general, and that of the U.S. government, specifically.

Background

Serbia is a small country with a population of only 7.4 million, unemployment about 18%, depending on the source, and a gross domestic product (GDP) per cap of €3424 in 2006, according to the World Bank. Even without a large export economy or a banking sector contaminated with sub-prime mortgages, Serbia is not immune from the global financial crisis. Real GDP growth averaged 7 percent during 2004–07, according to the IMF. However, for 2009, the IMF projects that Serbia's GDP growth will fall to 3.5%. Early 2009 estimates reveal a slowdown in industrial production (17.1%), a drop in exports (13.8%), and a decrease in retail sales (5.6%).[2] Moreover, the country's appetite for imports has resulted in an external current account deficit over 18 percent of GDP in 2008, up from 12.4% in 2007 and 5.7% in 2006, one of the highest deficits in the region.[3] The recent drop in consumer spending, said to be directly linked to increased credit rationing, is expected to have a positive effect on the trade deficit.

Serbia is mainly a country of ethnic Serbs, about 80% of the population. Its long and recent history regarding minorities, particularly Kosovars and Bosnians, continues to present ethnic and religious tensions, as evidenced by the demonstrations and damage inflicted on several embassies, including the U. S. Embassy, last February when Kosovo declared its independence.

Serbia's most vulnerable citizens tend to live in Southern Serbia, including four municipalities that border Kosovo and have a large Albanian Muslim population. Other vulnerable areas are the Sandzak, with its majority Bosnian population, and Vojvodina, with 26 nationalities on its territory. The Roma community is hugely discriminated against and thus marginalized.

Unlike its neighbors, Hungary, Bulgaria, and Romania, Serbia did not embrace economic and political reforms immediately after the fall of communism in

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Union to begin systemic reforms and harmonization of its laws with EU laws and standards.

[2] Quarterly Monitor of Economic Trends and Policies in Serbia, Issue 15, October-December 2008

[3] IMF Country Report No. 09/20 January 2009 and European Commission, Serbia 2008 Progress Report

1989. Instead, it continued to operate and isolate itself based on outdated economic, social, and political thinking and approaches. As such, it now lags behind many of its neighbors on several levels, particularly when it comes to rule of law, economic growth, and political stability. For example, it has yet to provide full compliance with the International Criminal Tribunal for the Former Yugoslavia (ICTY), which has caused some EU member states to withhold their support for Serbia as an EU candidate. Its gross domestic product (GDP) at purchasing power parity (PPP) per capita is $10,900 (2008 est.) compared to Hungary $19,000 (2008 est.), Bulgaria $12,900 (2008 est.), FYR Macedonia $9,000 (2008 est.), and Croatia $16,100 (2008 est.).[4]

It also has a laundry list of macroeconomic and business development challenges that to continue to stifle private sector development and dampens increased productivity and economic expansion. According to the IMF, the main hurdles Serbia needs to address are licensing, property registration, taxes, weak contract enforcement, high levels of corruption, weak competition policies, small private sector, sizeable public sector, large social transfers, and large infrastructure gaps. Labor costs and social protection transfers are exceeding high at more than 60 percent of total public spending.[5]

According to the World Bank Doing Business 2009 Rank, *Serbia ranks low regarding business development and business enabling* areas when it comes to the ease of doing business in the country out of 181 economies - starting a business 106, hiring 91, paying taxes 126, enforcing contracts 96, and obtaining business licenses 149. These issues will likely be covered in greater detail in the Part 2 assessment of this assessment.[6]

Labor Market and Workforce Development

Legal and Regulatory Environment

Changes in the Labor Law in 2001 with revisions in 2005 have helped to move Serbia toward harmonizing its labor laws and regulations with EU standards. Nevertheless, according to many interviewees, the labor laws remain weak, rigid, and rarely strictly enforced constraining the private sector.

The Labor Law, No. 70/2001 of 13 December 2001, as amended in 2005, and the 2008 General Collective Agreement provide the legal basis for employment, employer, and employee matters. These collections of laws are the responsibility of the Ministry of Labour and Social Policies.

While the minimum age for employment is 15, those under 18 must obtain

[4] CIA Factbook 2008
[5] European Commission, Serbia 2008 Progress Report
[6] http://www.doingbusiness.org/ExploreEconomies/?economyid=206

written parental or guardian permission to work. The Social Economic Council sets the *minimum wage*, 13,572 dinars (*approximately $250*) per month at the end of 2008. The *average monthly salary* in December 2008 was approximately 38,626 dinars (*approximately $569*).[7] Wage and social contribution arrears, which were common, particularly among the state owned enterprises (SOES) are not as widespread and are no longer reported to be substantial.

The Labor Inspectorate is responsible for enforcing the minimum wage and ensuring a safe workplace. It has been reported that even with "substantial" technical assistance, the Labor Inspectorate does not operate up to EU or international standards.

Serbia has basically a 40-hour workweek with a legal restriction that an employee may not work overtime for more than four hours a day or for more than 240 hours in a calendar year. Part-time and temporary work did not exist in Serbia until recently and the use of this flexible work arrangement is slowly evolving in Serbia.

In 2005, Serbia adopted the National Employment Strategy 2005-2010. This strategy is designed to achieve sustainable employment growth and increase the employment participation rate in the spirit of the Lisbon Strategy.[8] A key aspect of this strategy is to transform the National Employment Service (NES), Serbia's employment agency, from a bureaucratic institution focused on record keeping of mandatory social security into a modern public employment service, oriented to client needs and employment policy implementation. For example, in 2007, the NES changed its regulations to exclude as unemployed those who are not seeking jobs.

Even with the employment strategy and recent changes in the law, Serbia's labor laws and rules are not fully grounded to promote a modern, global labor market system. Employment creation has been inadequate to address Serbia's high unemployment, especially among women and youth. Wage, benefits, and hiring and firing rules are often vague, contradictory, and administratively burdensome. With job creation being critically important to Serbia's economic, social, and political well being, the labor market should be re-structured immediately to facilitate employment while advancing both employers' and employees' rights, according to several we interviewed.

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[7] The Republic Statistical Office reduced the average monthly wage to approximately 30.000 dinars at beginning of 2009, based on acceptance that its methodology in calculating the average wage was flawed

[8] The Lisbon Strategy, also known as the Lisbon Agenda or Lisbon Process, was adopted by the EU in 2000 as an action plan aimed at making the EU "*the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment by 2010*".

The Labor Force

Serbia has a rapidly aging workforce challenged with high unemployment (18% in 2008 and expected to grow to 19% this year), and particularly high youth unemployment (44%). Its labor force of approximately 3.2 million people consists of 2.8 million employed, 25% in the informal sector, and 14% or 450,000 unemployed, according to ILO methodology. About 17% of the population is aged 65 or older while the 2008 fertility rate (births per woman) of 1.6 has been below the reproductive rate since the 1960s. The replacement fertility rate is roughly 2.1 births per woman.

In 2006, more than half of Serbia's 3.2 million workforce was between the ages of 35 and 54. Twenty-three percent of the workforce then was between the ages of 25 and 34. Over 63% of the population is working age (15-64). Only 27.2% of the total population (53.5% of the population were of working age) were employed. [9]

QuickTime™ and a
decompressor
are needed to see this picture.

Source: ILO 2007

The private sector now employs the bulk of the workforce, approximately 71% of all workers, with the balance, 24.6%, employed in the public sector, including the state-owned enterprises (SOES). About 2.4% of the workforce is still with the socially-owned companies, "worker-owned" companies that are slowly disappearing.

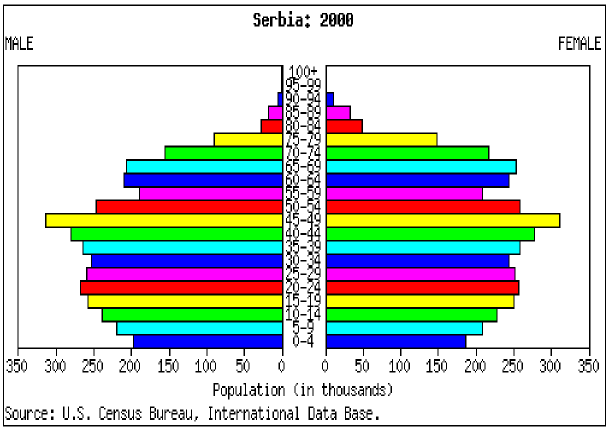
Labor costs are relatively low in Serbia. The minimum wage for the period July-December was set by the Social Economic Council at approximately $250 per month. According to figures released in December 2008, the average take-home salary in November 2007 was approximately $500. The gross wage in Serbia was about $650 in 2007 compared to $527 in FYR Macedonia, $300 in Bulgaria, and $528 in Romania.[10]

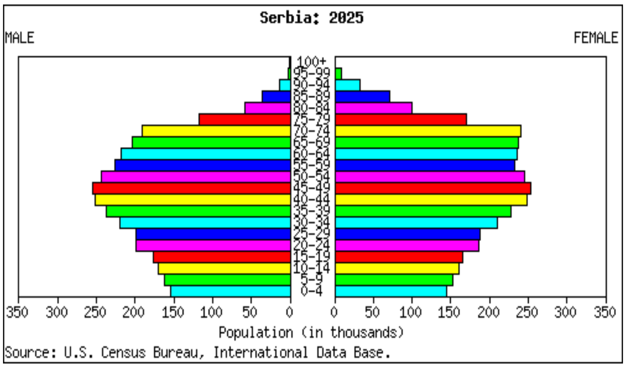
[9] INEKO and ESPI Institute, Labour Market Reforms in Serbia and Slovakia, 2008
[10] http://www.databasece.com/en/in-emerging-markets

Average monthly gross earnings in national economy in US$ at current exchange rates	
Country	**2007**
Bulgaria	301
Croatia	1 313
Czech Rep.	1 068
Estonia	991
Hungary	1 006
Latvia	775
Macedonia	527
Poland	973
Romania	578
Russia	528
Serbia	**649**
Slovakia	814
Slovenia	1 761
Ukraine	268
Source: Database Central Europe http://www.databasece.com/en/in-emerging-markets	

Demographic trends and projections

Serbia's working age population is projected to decline in both relative and absolute numbers after 2010. While the share of the working age population to the total population is projected to increase from 67.1% in 2002 to 68.3% in 2012, the absolute number of the working age population is projected to drop almost 150,000, from 5,030,000 in 2002 to 4,885,000 in 2012, a net population loss of some 350,000 over the ten-year period. Between 2006 and 2012, an average annual drop in the working age population of 15,000 is expected, particularly as the population of retirees increases during that period.





Employment and Wages

The Serbian Bureau of Statistics conducts two surveys, the RAD survey and the Labor Force Survey (LFS), to measure employment and wages. The RAD survey measures only formal sector workers with employment contracts for whom social security contributions are paid (excludes agricultural workers, unpaid family workers, and army and police workers not covered by the general pension system). The LFS measures a broader section of the labor force based on interviews of individuals from a national sample of households (informal, formal, agriculture workers, unpaid family members and army and police workers).

According to the National Bureau of Statistics and Informatics, 1,985,084 persons were employed in Serbia in May 2008. That month, of the 773,335 registered unemployed, 54% were women.

The LFS reveals an increase in the employment rate from 51.3% in 2007 to 53.3% in 2008 among the working age population (15-64), an increase of about 120,000 workers during that period. The unemployment rate from October 2007 to October 2008 decreased from 18.8% to 14.7%, more than a 100,000 reduction in the number of unemployed. This change is partly attributed to an improvement in the quality of the LFS, without which the unemployment rate for that period would have been about 17.5%. The RAD survey, on the other hand, draws attention to the presumably higher quality jobs (formal sector registered workers) and reveals a decrease in employment, particularly in manufacturing where 9,000 jobs were lost, 2.5% of the employed in that sector. Retail lost 3,000 jobs, 1.5% in that sector.[11]

Who's Working Where

Long-term unemployment (12 months or more) is about 80% of total unemployment and youth unemployment is 44%.[12] 60% of the Roma population is unemployed and is thus the most vulnerable ethnic community in the labor market.[13] Women's average wages were 16 percent lower than those of men in 2008. There were 54 percent more women unemployed than men, and only 21 percent of women occupied management positions.[14]

According to Serbia's Statistical Office, the highest unemployment rates are in Central Serbia (13.8%), Belgrade (14.2%), and in the Vojvodina agricultural region (14.2%).[15] Central Serbia is also the region with the highest incidence of long-term unemployment. The workforce is characterized as having low educational attainment, primary school or less (22% of those unemployed in 2006), and without sufficient qualified skills. According to the 2002 Census, about 45% of the workforce were low-skilled (primary education or less) and 41% medium-skilled (completed secondary education).

2004-2005 Working Age Population

	2004			2005		
	Total	Male	Female	Total	Male	Female
Labour force participation rate	66.4	75.1	57.9	65.2	74.3	56.2
Employment rate	53.4	63.1	44.0	51.0	61.3	40.8
Unemployment rate	19.5	15.9	24.1	21.8	17.6	27.4
Long-term unemployment (12 months and more)	77.5	75.7	79.0	79.0	78.4	79.6

Source: LFS 2004 and 2005

According to the World Bank (2006), informal employment in Serbia amounts to 43% of all employees and 27% of wages earners, excluding farmers. Youth and the less educated tend to be overrepresented in the informal sector. Small businesses contribute over 45% of GDP, 27% of exports, and 55% of total employment.[16]

2005 Working Age Population by Age and Education

[11] Quarterly Monitor of Economic Trends and Policies in Serbia, Issue 15, October-December 2008
[12] Gligorov, Vladimir, Anna Lara, Michael Landesmann, Robert Stehrer and Hermine Vidovic, *Western Balkan Countries: Adjustment Capacity to External Shocks, with a Focus on Labour Markets*, The Vienna Institute for International Economic Studies, 2008
[13] Arandarenko, Mihail and Aleksandra Nojkovi, *The Labour Market in Serbia Overview*
[14] http://www.state.gov/g/drl/rls/hrrpt/2008/eur/119103.htm
[15] http://webrzs.statserb.sr.gov.yu/axd/en/index1.php?SifraVesti=316&Link=
[16] ETF Country Plan 2009

	Share in Population 15-64	Share in Unemployment	Share in Employment
Age			
15-24	19.2	23.1	7.0
25-64	62.1	71.6	80.0
55-64	18.6	5.3	13.0
Education			
Less than elementary	7.4	4.0	5.4
Elementary	24.1	16.9	17.2
Vocational	20.2	27.7	22.7
Secondary	35.3	40.4	36.5
College or more	13.0	11.0	18.2

Source: LFS, 2005

In 2008, real wage growth was 5.5%, down from 14.6% in 2007. Average monthly gross wages (employer's total per employee expense, including payroll taxes) were 45,723 Dinars (€572) in 2007 compared to 53,868 Dinars (€660) in 2008.[17] The construction and manufacturing industries experienced year-on-year growth of 7.6% and 5.9%, respectively. While the hotel and restaurant (1.2%) and the real estate (4%) sectors experienced year-on-year real wage decreases.

Serbia Gross Wages And Total Labor Costs, In National Currency And Euros

	2001	2002	2003	2004	2005	2006
Gross wages in Dinars	8739.0	13260.0	16612.0	20555.0	25514.0	31745.0
Total labor Costs in Dinars	10474.0	15892.0	19993.0	24234.0	30081.0	37427.3
Gross wages in Euros	147.0	218.0	255.0	282.0	307.0	377.7
Total labor costs in Euros	176.0	262.0	306.0	332.0	362.0	445.3

Source: World Bank

Trade Unions

Trade unions are relatively weak in Serbia. They are primarily organized through three confederations - the Federation of Autonomous Unions of Serbia (SSSS), the Branch Union Confederation 'Independence' (UGS Nezavisnost), and the Association of Free and Independent Trade Unions (ASNS). There are also a number of company-specific unions, mainly in SOES and independent of the confederations. UNISON is a public sector union and member of the British TUC. Only about 20% of the workforce is said to be trade union members, the majority working in SOES or for the government.[18]

[17] Effective January 2009, the Serbian Bureau of Statistic changed the methodology for calculating the average wage, namely, downward to include generally lower wages paid by entrepreneurs.
[18] http://www.unison.org.uk/international/serbiamontenegro.asp

Labor Market Inefficiencies

While Serbia is considered a low labor cost country in *relation to its neighbors*, it still has a host of labor market challenges to overcome. First, Serbia urgently needs to improve the efficiency of its labor market. Even with the many labor related reforms Serbia has undertaken, new business growth in Serbia has been too little and far too slow to address the dismal and growing unemployment situation. Further reforms are needed to improve the effectiveness and efficiency of the labor market directed as an integrated part of improving the business climate and increasing productivity. Next, labor regulations should be more flexible, but not at the expense of undermining employees' rights and protections. Most importantly, labor laws and regulations should be enforced consistently and fairly. For this to happen, all of the key stakeholders in Serbia – government, employees, employers, and educators - must collaborate and be moved to action to improve the labor market, workforce employability and readiness, and business development climate in Serbia.

Active Labor Market Measures (ALMMs)

As the economy contracts and unemployment increases, countries often employ active labor market measures (ALMMs) to help redundant workers move to employment more quickly. ALMMs generally focus on skills training, job counseling, public works programs, and even subsidized wages for the unemployed. Serbia spent only 0.1% of its GDP on ALMMs in 2008, barely enough funding to assist 5% of the registered unemployed.[19] An increase in ALMMs expenditures, while needed to counter the effects of layoffs and low job creation, is unlikely in this period of tight fiscal constraints. Nevertheless, Serbia plans to provide career counseling, subsidized apprenticeships for 10,000 recent graduates, on-the-job training for 3,000 unemployed, subsidized employment for the disabled and older workers, grants (€1300) for start-up businesses, and public works jobs for 10,000 unemployed. The 2009 budget for these ALMMs is 3.5 billion Dinars.

Pension Reform

The Public Pension System

Pensioners can often count on an increase in benefits around election time. Serbia is no exception. Leading up to the 2008 election, Serbia promised and delivered at the end of 2008 a 10% increase in pension benefits, with average pensions increasing by 13 percent in 2009. As such, pensions are one of the largest expenditures for the Government of Serbia with this recent increase and years of wage indexation, requiring a budget transfer to meet the growing

[19] Arandarenko, Mihail Highlights 4: Effects of the Global Financial Crisis on Serbian Labor Market, in the Quarterly Monitor of Economic Trends and Policies in Serbia, Issue 15, October-December 2008

pension deficit of 40% of total pension expenditures, up from 10% of the budget in 1999. In 2009, the GOS projects to pay 25% of its total budget for pensions, up from 20% in 2008.

The social insurance system provides an old-age pension, health, and unemployment benefits. Employers and employees *each pay* 17.9% of gross wages in social protection contributions - pensions and disability (11%), health insurance (6.15%), and unemployment insurance 0.75%).

Beginning in 2008 and to 2011, the retirement age is being increased gradually by 6 months a year to age 65 (men) and age 60 (women). At least 15 years of coverage plus the required retirement age are needed for a minimum pension. A full pension is available to those with at least 40 years of paid-in contributions. Privilege pensioners, those in special work categories, such as miners and ballerinas, need fewer years of service in order to receive a full pension.

The minimum monthly earnings for contribution purposes are equal to 35% of the national monthly average wage, 39,331 Dinars in January 2008. The maximum monthly earnings for contribution purposes are equal to five times the national monthly average wage. The minimum pension is 66% of the net wage, 30,362 in March 2009, about 20039 Dinars ($278)

A disability pension is available for those below the retirement age and deemed totally incapable of working. The required contribution period can be as low as 1 year for those under age 20 to 5 years for those aged 30 or older. There is no minimum qualifying period for a disability resulting from a work injury or an occupational disease.

Survivor pensions are available if the covered deceased had at least 5 years of coverage or was eligible for a disability pension and the survivor is over age 48 if a widow, age 53 if a widower, or disabled, or caring for a child younger than age 15 (age 26 if a student, no limit if disabled). Dependent parents, grandchildren, brothers and sisters may also be entitled to survivor pensions.

Between 2008 and 2011, the age requirement for survivors is being increased gradually to age 50 for a widow, age 60 for a dependent mother, and age 65 for a dependent father.

Serbia has an unfunded defined benefit mandatory pension system, commonly referred to as a pay-as-you-go (PAYG) pension system. In a PAYG pension system, current contributors provide for current pensioners pension income. Serbia's PAYG system had three funds – employees, self-employed, and farmers – which are being merged starting last year.

With the assistance of USAID and other donors, Serbia in 2001 began reforming its unsustainable public pension system. At that time, the pension system experienced large deficits because the number of pensioners was growing while the number of contributors was decreasing. The system also experienced low pensions, high contribution rates, easy access to pensions for those facing unemployment, and a large informal sector that evaded contribution payments.

The Pension Reform Begins

In 2001, Serbia introduced several pension reform measures to begin to address the inadequate and financially unsound pension system. The reforms at that time included:

- Statutory change in pension indexation (from wage to wage and CPI, the 50/50 Swiss model)
- Uniform minimum pensions
- Decrease in the contribution rate from 32% to 19.6%, later increased to 22% (11% of gross wages paid by the employer and 11% paid by the employee)

In 2003 and 2005, further pension reform measures were introduced:

- Increases in the retirement age
- Move to CPI indexation only
- Consolidation of the three public pension funds

The Pension Administrative Agency is largely a benefits processing institution. It has 3,750 employees in 150 offices throughout Serbia and is said to be extremely inefficient. With a declining contribution base while seeing a growing pensioner community, it struggles with outdated equipment and very little employee training to keep up with the needs of this agency. It is, however, optimistic that the $30 million World Bank loan will be a tremendous help in modernizing its operations.

Voluntary Pensions

In 2006, Serbia introduced voluntary pension funds as a likely springboard to mandatory privately managed pension funds in a three-pillar pension system.[20] Recent research and analysis have all but ruled out the introduction of a Pillar 2, a mandatory funded pension scheme, as too costly and too innovative for the current financial market at this time. For more on the feasibility and timeliness of a mandatory private pension scheme in Serbia, see *Challenges of Introduction of the Mandatory Private Pension System in Serbia,* a USAID funded research project published by the Center for Liberal-Democratic Studies, 2009.

There are now 10 voluntary pension funds (VPFs) with 150,000 clients and €50 million in assets, only 0.15% of GDP. Of the 10 VPFs, 9 are foreign owned. The 1 domestic VPF is managed by Serbia's largest insurance company, a socially owned enterprise, and has 45% market share. The two next largest funds have about 20% each in market share.

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[20] Several countries in the region (for example, Poland, Croatia, Hungary, and Bulgaria) have adopted the three-pillar pension system. Pillar 1 is generally a public pension fund (funded or unfunded), Pillar 2, a mandatory funded scheme, and Pillar 3, voluntary pension funds.

Most VPF participants either receive a match in contributions from their employer or the employer is the sole contributor to the fund. Only about 5% of participants contribute without an employer-employee relationship.

At the end of 2008, about 80% of the VPF assets were in cash, which returns about 16% annually in local currency. Some assets were in frozen currency government bonds, yielding 6-7% annually, domestic equities, and some real estate. The VPFs, which may invest up to 10% in foreign investments, hold no foreign assets.

Serbia's capital market is extremely shallow without any domestic corporate or municipal bonds and only 3 class A companies listed on the stock exchange. The government of Serbia recently began to issue 3-month treasury notes, yielding the same as cash, about 16% annually in local currency. The VPFs have begun to buy these notes.

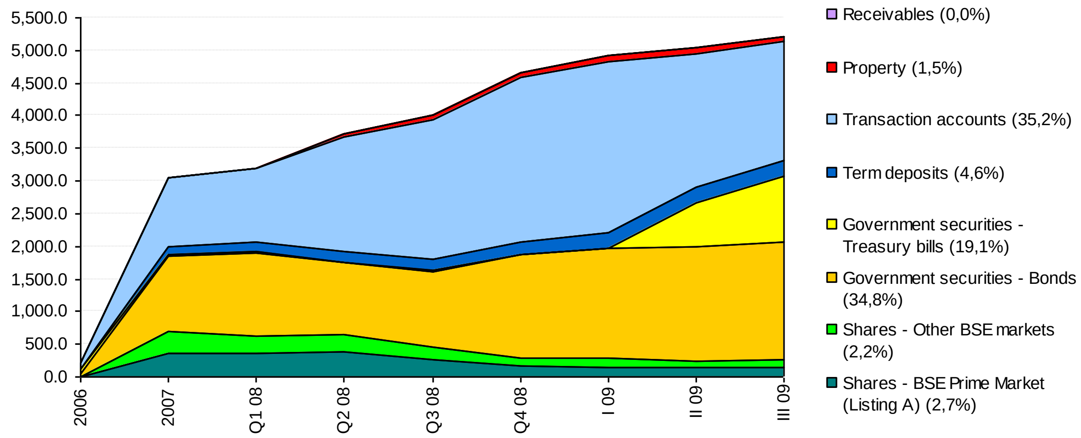
Net Assets of Voluntary Pension Funds (in local currency in millions)	**2006**	**2007**	**2008**	**2009 Q1**
Total	**225.9**	**3,045.6**	**4,640.6**	**5,204.4**
Delta Generali	225.9	670.9	1,080.2	1,235.5
Raiffeisen Future	-	122.1	373.5	425.8
Garant	-	58.7	203.0	244.9
DDOR Penzija plus	-	725.7	869.8	934.7
Dunav	-	1,440.5	1,997.0	2,213.7
Nova penzija	-	23.3	74.7	89.1
Triglav penzija	-	4.4	23.0	27.7
HYPO	-	-	18.8	30.9
Soc. Gen. Štednja	-	-	0.2	1.1
Soc. Gen. Ekvilibrio	-	-	0.3	0.9

Age Structure of Pension Fund Participants

Gender	0-19	20-29	30-39	40-49	50	51	52	53+	**Total**
Male	137	8,617	26,521	31,351	3,316	3,180	3,389	20,779	97,290
Female	85	5,659	17,606	21,825	2,412	2,237	2,383	9,675	61,882
Total number of users	222	14,276	44,127	53,176	5,728	5,417	5,772	30,454	159,172
Percent share of total	0.14%	8.97%	27.72%	33.41%	3.60%	3.40%	3.63%	19.13%	100%

Accumulated funds as a percentage of net assets	0.05%	6.06%	28.60%	36.52%	3.94%	3.73%	3.97%	17.13%	100%

Composition of Voluntary Pension Fund Assets



According to several sources, the VPF market could be more robust if there were a strong financial literacy campaign in Serbia and if the tax treatment of the funds were more favorable. Currently, the VPFs receive only a partial tax exemption for contributions, about €30 per person per month, which tends to be the average contribution per participant. Advocates of greater pension savings argue for greater tax incentives for the VPFs. However, the nascent capital market remains a challenge for the private pension fund system even if greater tax incentives were provided and employers or savers contributed more to these schemes.

Pension Reform Unfinished Business

Serbia's pension reform is not finished. The public pension system continues to need systemic reforms if it is ever to attain a sound financial footing. The voluntary pension system is nascent, which some view as having too little traction to address pension adequacy for future retirees. It should be developed and expanded to help citizens save for their retirement as part of the overall old-age security structure in Serbia.

The public pension system has 2.6 million contributions and 1.6 million pensioners, a dependency ratio (contributors to pensioners) of 1.6. Even with the increase in the retirement age, some pensioners can retire as early as age 50. Moreover, the pension deficit as a percentage of GDP, while shrinking gradually, -8.9 in 2003, -8.0 in 2004, and -7.4 in 2005, crowds out other public spending, according to the IMF.[21] The government budget provides

[21] As part of the recent €400 million IMF loan, structural conditions include a nominal freeze of pensions and civil service salaries in 2009, which the GOS agreed to as evidenced in a Letter of Intent to the IMF dated December 2008 (Prime Minster Mirko Cvetković, Minister of Finance Diana Draguyinovic , and Governor of the National Bank of Serbia Radovan Jelasic are signatories to this

40% of all pension expenditures. The average pension as a share of the net wage has also been shrinking gradually 70.5% in 2003, 67.9% in 2004, and 61.8% in 2006. Nevertheless, pension spending was 12.1% of GDP in 2006 and 11.8% of GDP in 2007.

Until the government can reasonably assure workers an adequate pension income in an environment that is fiscally sound and sustainable, pension reform continues to be a major challenge for Serbia. Moreover, the pension system should be modernized and insulated from political manipulations and election year ad hoc changes. Serbia needs a national pension strategy that is fully integrated in a national employment and job creation strategy. Thus, there is much work yet to be done to strengthen Serbia's pension system to ensure its sustained stability.

Serbia Economic Growth Activity (SEGA)

Since 2001, USAID/Serbia has been engaged in assisting the Government of Serbia in macroeconomic and private sector development. More recently, USAID has been working with Serbian government counterparts, non-governmental organizations, bilateral and multilateral donors, and other US Government agencies to help strengthen the legal and regulatory environment in Serbia with a keen focus on private sector development and job creation. This work is being done under the *Serbia Economic Growth Activity (SEGA),* a $20 million project (GEG-I-00-04-004-00, Task Order 6) covering the period 2006 to 2010. The key counterparts are the National Bank of Serbia (NBS), the Ministry of Finance (MOF) and its Serbia Tax Administration (STA), the Serbian Securities and Exchange Commission (SEC), and nongovernmental institutions such as consulting firms, economic research institutions, and universities. The implementing partner is Bearing Point.[22]

The aim of this project is expected to result in heightened investor confidence in the rules and behavior of key institutions affecting economic growth and investments in Serbia.

Key project components include:

- Macroeconomic policy development capacity building
- Formulation and implementation of laws, policies, and procedures relating to financial, fiscal, and macroeconomic development
- Supervisory oversight and risk management of the financial sector to improve the availability of credit and investment opportunities
- Tax policy and administration and fiscal decentralization reforms
- Public information and education programs for the key reform programs

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letter). Serbia expects the IMF to approve a €3 billion loan this May for additional budget support.

[22] Deloitte LLP received approval from the United States Bankruptcy Court in April 2009 to purchase Bearing Point's North American Public Services practice. The transaction is expected to close in May 2009.

Several, but not exhaustive, key results to date include:

- Supported tax policy reforms and modernization of the tax system to create a business-friendly environment
- Facilitated the next stages of pension reform, voluntary and mandatory private pension funds, and provided public education on the importance of these initiatives
- Helped the NBS, MOF, and other key government economic institutions and agencies develop and implement their reform priorities, particularly in the area of fiscal reform
- Aided completion of the privatization process for state- and socially-owned enterprises
- Assisted the formulation and implementation of laws, policies and procedures relating to financial sector development and supervision
- Supported the operational and information technology (IT) requirements of the NBS to assist in improving the payments system and implementing financial sector reform

Those interviewed have given USAID's SEGA project high praise. The project is generally deemed efficient and extremely responsive to the government of Serbia's needs. One person expressed his view *that without USAID and SEGA, Serbia's economic situation would be much worse today.* Moreover, the SEC is particularly keen on USAID's continued support.

The technical assistance provided the National Bank under the SEGA project has also been well received and deemed invaluable. In fact, one of the larger voluntary pension funds with operations throughout Central and Eastern Europe considers the National Bank's operations among the top in the region. This VPF attributes the NBS's success to USAID's SEGA project.

The Department of Pensions and Disability Insurance within the Ministry of Labor Employment and Social Policy (MOLESP) were emphatic about the very good technical assistance that it had received from USAID's SEGA project. It was particularly appreciative that three of its staffers received pension training in Washington, DC. It also found the analysis of the prospects of introducing the Pillar 2 mandatory pension scheme most useful for planning and policy purposes. Additionally, this department is most grateful that USAID assisted Serbia in introducing the Pillar 3, the voluntary pension system.

What remains, according to several government officials, academicians, and private sector pension experts, is a national pension system strategy to put the pension system on sound financial footing. Also needed, according to the interviewees, is financial literacy training and education to promote the need to save for retirement. As one interviewee said, "*I should have been taught how to save, but I don't know how.*"

Other Donors

Since 1997, USAID has been one of the largest bilateral donors to Serbia. Germany is also a major donor as are the multilaterals, particularly the World Bank and the IMF. The EU is expected to be the largest donor in the mid-term as it provides more and more funds to Serbia as a pre-candidate EU accession country.

The EU is slated to provide Serbia about €200 million annually as the country progresses toward EU accession. For 2009, the GOS is expecting the EU to provide €100 million in budget support from the EU's Instrument for Pre-Accession Assistance (IPA) funds. It is also reported that the EU has set aside €1 billion of non-refundable aid for Serbia for the period 2007–2012 for implementing reforms regarding Serbia's EU integration process. Total EU accession loans and grant could reach €2 billion.[23]

The World Bank provided a $30 million loan to Serbia about 5 years ago, which Serbia has recently begun to access. These funds are to upgrade the tax, health, and pension registry of employees and employers and improve the administrative capacity of the NBS.

The National Employment Service (NES) has received active labor market technical assistance from several donors:

- Germany - a capacity building-twining project;
- EU – vocational education training for 2,000 unemployed;
- UNDP – a youth employment program funded by Spain; and
- ILO - a youth employment program to begin this year

See Appendix B for a list of financial sector and macroeconomic donor support to Serbia.

Recommendations

One of the greatest challenges that Serbia faces is improving its employment situation. Double digit unemployment and youth unemployment upwards of 40% is a recipe for political, economic, and social instability. Serbia desperately needs sustainable employment growth decisively driven by private sector development. It also needs to reduce the public and informal sectors to eliminate the negative impact that these sectors are having on private sector development. Helping Serbia achieve sustainable economic growth that encompasses inclusive social development and good governance should be the basis of USAID/Serbia's macroeconomic focus over the next five years.

The challenge, therefore, is to assist Serbia in producing more and better jobs for today's and tomorrow's workforce. To do so is, without question, heavily

[23] http://www.seebiz.eu/en/macro/srbija/eur-168mn-allocated-to-serbia,41750.html

contingent upon an improved and reliable legal and regulatory environment that is fair, effective, and efficient. As such, the USAID/Serbia should remain engaged in assisting Serbia in adopting adequate laws and regulations and in modernizing government administrations. USAID/Serbia should remain heavily engaged in helping Serbia develop a modern business environment system that can grow and thrive competitively. Without such, private sector led job creation will continue to remain weak, and thus, undermine the political, economic, and social stability that the Serbian citizens seek.

Based on the various recommendations received during this assessment (Appendix C) regarding possible assistance that would help the country accelerate private sector development and improve the business-enabling environment, four are strongly recommended. Assist the GOS:

1. Harmonize the financial and business legal and regulatory environment, including administration and enforcement, with EU laws and standards;
2. Develop a national strategy and action plan to address business expansion, job creation, and a workforce trained and capable of making a significant contribution to increasing productivity and profitability, and ultimately increased economic growth;
3. Develop a national pension reform strategy that addresses the long-term fiscal stability and sustainable of the pension system; and
4. Assist Serbia access any and all EU pre-candidate accession funds far greater than any other recent EU country has done to date and to leverage and enhance Serbia's bilateral support, in general, and that of the U.S. government, specifically.

Why these four recommendations?

The aim of these particular recommendations, were the Mission to adopt them, would be *More and Better Jobs for Greater Economic, Social, and Political Stability in Serbia.* The beneficiaries of such a successful program would be business owners, employees, pensioners, investors, and society as a whole. These four recommendations are inextricable pieces of a whole. Businesses need an adequate and reliable legal and regulatory environment in other to compete globally and thrive. They also need reasonable and adequate financing and investments as well as a competent and capable workforce to succeed. The workforce needs to be adequately trained to be employable (human capital development), hired (career counseling and guidance), and ultimately improve their standard of living (increased wages and savings). Society needs a balance between the self-reliant and the less productive or capable. And, workers need to retire with dignity with an adequate pension income that does not crowd other societal needs – education, national security, health, etc.

The pension system is fundamentally broken. The pension expenditures run a deficit of 40%, which is funded by general budget. Moreover, total pension expenditures are 25% of the total government budget, about 5.5% of GDP. Without question, the pension system is unsustainable and needs reforming. From the high pension deficit to the privilege pensions that allow some workers to retire as early as age 50, Serbia's pension system is fiscally unsound and unsustainable. It needs systemic reform immediately.

Serbia is scheduled to receive €584.4 million from the EU Instrument of Pre-Accession Assistance (IPA) program for 36 projects with a 2010 deadline for implementing the projects. Additional funds are expected until EU accession is granted, likely in 2015 or so by some accounts. It seems as these EU pre-accession funds may not be fully or even significantly accessed without various ministries, NGOs, and others receiving training and assistance on how to access those funds. With strategic planning coupled with grant and proposal writing training directed at the IPA funds, USAID could help Serbia capture these EU funds, thus leveraging Serbia's donor assistance.

USAID's strength lies in its ability to provide technical assistance and advice on policy formulation and reform processes, in general. Specifically, USAID/Serbia is well-suited and well-positioned in Serbia, having worked closely with the government, NGOs and other donors, to continue to provide economic growth and private sector development technical assistance.

USAID should now focus its energy and resources on assisting Serbia with not only drafting good laws and regulations, but also with implementing and enforcing those measures. Sound governance, accountability, transparency and enforcement is needed in Serbia to ensure a durable reform process and to speed-up the results needed to move the economy along faster.

It is further recommended that USAID/Serbia take a flexible approach as it continues to provide macroeconomic strengthening assistance to Serbia. Since 2001, Serbia has experienced continued political and economic instability. Its reform path, while steady on some levels, has not had the successes that some of its regional neighbors have had in the last 10 years. As such, USAID/Serbia must be posed to respond to Serbia's fluid political, social, and economic environment in order to seize development opportunities as they present themselves. Thus, the Mission may want to temper its top-down approach to macroeconomic and private sector development with a more bottom-up approach.

This current global economic and financial crisis makes it difficult, if not impossible, to gauge the level and extent that Serbia and its neighbors will be impacted by this economic downturn. As such, an instrument that can move easily between assisting the policymakers when the political will is pronounced and assisting new businesses and the private sector expand is highly recommended.

Economic growth focused on private sector development is essential for Serbia if it is to generate opportunities for employment and income generation. A strong and dynamic private sector is crucial for long-term economic growth, and a necessary ingredient for sustained economic, social, and political stability in Serbia.

USAID/Serbia is uniquely qualified to continue to help Serbia close many of its legal and regulatory and business development gaps. It is also uniquely qualified to help Serbia create the right economic growth policy environment that will stimulate investments and provide resources for investments in the workforce, infrastructure, and the business community.

Appendix A – Serbia Demographic Overview

Population Mid-2008	7,354,000
Birth Rate (annual number of births per 1,000 total population)	10
Rate of Natural Incr. (birth rate minus death rate, expressed as a %)	-0.4
Population Mid-2025 (projected)	6,719,000
Population Mid-2050 (projected)	5,819,000
Population Change 2008-2050 (projected %)	-21
Population Gain/Loss, 2008-2050	-1,535,000
Infant Mortality Rate (infant deaths per 1,000 live births)	7.4
Total Fertility Rate (TFR)	1.4
Population Age <15 (%)	16
Population Age <15	1,149,000
Population Age 65+ (%)	17
Population Age 65+	1,268,000
Life Expectancy at Birth, Both Sexes (years)	73
Life Expectancy at Birth, Males (years)	71
Life Expectancy at Birth, Females (years)	76
Urban Population (%)	56
Population Living in Urban Areas of 750,000+, 2005 (%)	14

Source: Population Reference Bureau

Appendix B: Donor Map In Area Of Sega Activities

(not available)

Appendix C:

What Options Emerged (Recommendations) From The Interviews?

FOR EMPLOYERS/BUSINESSES?

- Access to Credit
- Workforce Development for a more skilled and relevant labor force
- Greater private pension fund tax incentives
- *"Save the private sector from the government so that it can grow and thrive; this has nothing to do with the global financial crisis."*
- Improve the tax burden
- Reduce the regulatory burden
- Reduce/eliminate the informal sector
- Have a stand-alone workforce development activity or increase the funds for workforce development in the competitiveness project
- Help businesses become more productive
- Help businesses value employee training
- Help businesses improve standards so they can export more
- Conduct employer survey to ascertain job demand

FOR EMPLOYEES?

- Focus on Workforce Development to upgrade skills and address increasing layoffs as economy continues to plunge
- Support the introduction of Pillar 2, the mandatory private pension scheme
- Educate citizens about the importance of saving for retirement; "*I should have been taught how to save, but I don't know how."* (Perhaps a financial literacy campaign throughout Serbia is a GDA possibility with MasterCard, Visa, and/or the local banks and insurance companies. Does USAID/Serbia want to explore this possibility?)
- Greater private pension fund tax incentives
- Target EG to the rural poorer areas
- Assist the disabled with job training
- Assist returning Serbians find jobs

FOR THE UNEMPLOYED?

- Workforce Development for a more skilled and relevant labor force to move the economy forward and reduce poverty→ certificate or degree adult education programs for dropouts
- Target EG to the poorer areas, generally the rural areas and South Serbia

FOR POLICY IMPROVEMENT?

- *Develop a labor market policy focused on improving the employment rate and the labor force quality with broad participation and input from the relevant Ministries, educators, think tanks, and the private sector to provide a more efficient response to changes in labor supply and demand*
- Develop pension reform strategy for a sustainable pension system integrated in a private sector development and job creation strategy
- Target social assistance to the very poor → Social Assistance Strategy → Farmers' pensions and noncontributory pensions
- Tax reform, including tax incentives for the voluntary pension funds
- Reduce public sector employment
- Shrink the informal economy
- Advance WTO accession
- Improve data collection and analysis capabilities in the government
- The government needs to collaborate across ministries for greater efficiency and better results
- Analyze what are the impediments to business development and job creation

FOR CAPACITY BUILDING?

- Central Bank – bank restructuring, capital adequacy and bank stress test procedures, and implement of Basel II (See UST Larry McDonald re Treasury TA)
- Tax enforcement
- Develop more business start-ups
- Develop medium to small companies, particularly manufacturing and services (not financial sector, which is fairly developed – banks, investment funds, and insurance companies)
- Privatize SOES
- Develop capable government middle-level managers (ministers and political appointees turn over too frequently)
- Stress human resource development capacity building in the public and private skills – *Number one asset in Serbia is youth population*
- Develop cadastre system and enforcement it
- Improve data collection and analysis to improve the quality of policies, laws, and regulations
- Introduce financial literacy in society, particularly the schools
- Increase the capacity of the voluntary pension fund association
- Improve government administration efficiency with long-term sustainable policies

- Support the draft Securities Law toward embracing EU and international standards and best practices
- Government needs to conduct impact assessments of how laws are implemented and what results are they are achieving
- Improve the civil society so that citizens influence government policies and direction
- Integrate USAID’s programs across several ministries within one activity to promote collaboration across a variety of government entities
- Continue to support Junior Achievement and connect youth programs to the private sector
- Institutionalize career counseling

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