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**For meeting of  
Board: Tuesday, March 16, 2004**

FROM: Vice President and Corporate Secretary

**Serbia and Montenegro: Poverty Reduction Strategy Paper  
and Joint IDA-IMF Staff Assessment of the PRSP**

1. Attached are the Poverty Reduction Strategy Paper and Joint IDA-IMF Staff Assessment of the PRSP. These reports are being circulated to the IMF Board on a lapse of time basis. The PRSP will be discussed together with the *Serbia and Montenegro: Transitional Support Strategy Update for FY04*, that is being distributed separately (IDA/R2004-0035).
2. The PRSP was prepared by the Governments of Serbia and Montenegro. It contains a diagnostic assessment of poverty in Serbia and Montenegro, and a vision for a comprehensive poverty reduction strategy. The JSA also highlights the areas which need to be developed further, to be reflected in the first annual progress report of the PRSP. The JSA indicates that the Serbia and Montenegro PRSP provides an adequate basis for World Bank support.
3. Questions regarding these documents should be addressed to Ms. Cooke (ext. 38727), Mr. Domac (ext. 81138), or Mr. Courtney (ext. 85242).

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**SERBIA AND MONTENEGRO**  
**POVERTY REDUCTION STRATEGY PAPER**  
**AND**  
**JOINT IDA/IMF STAFF ASSESSMENT**

February 18, 2004

South East Europe Country Unit  
ECCU4  
Europe and Central Asia Region

THE INTERNATIONAL MONETARY FUND AND  
INTERNATIONAL DEVELOPMENT ASSOCIATION

SERBIA AND MONTENEGRO

**Joint Staff Assessment of the Poverty Reduction Strategy Paper**

Prepared by the Staffs of the International Monetary Fund  
and the International Development Association

Approved by Carlo Cottarelli and G. Russell Kincaid (IMF) and  
Shigeo Katsu and Gobind Nankani (IDA)

February 18, 2004

**I. INTRODUCTION**

1. Economic performance in Serbia and Montenegro (SAM)<sup>1</sup> has been solid since the end of the Milosevic regime in late 2000; however, with exceptionally difficult initial conditions, a lot remains to be done in order to achieve strong sustainable growth and a viable external position. Real GDP rebounded from a sharp decline in 1999 stemming from the Kosovo conflict—growing at an annual average rate of 4.5 percent in 2000–03—but remains at a low level by historical standards; inflation declined from over 100 percent at end-2000 to a single-digit level by end-2003; and official foreign reserves rose to the equivalent of 4 months of imports from a negligible level 3 years ago. Despite political turmoil and delays related to the constitutional transition, the structural reform record has been impressive, with significant progress in dealing with the main problem banks and in implementing the privatization and enterprise restructuring program. Nonetheless, part of the financial system remains fragile, the enterprise sector is still largely unstructured and inefficient, and unemployment remains a concern. Key challenges include creating an enabling business environment, improving governance, and addressing poverty. Meanwhile, the European Union has begun preparation of a Feasibility Study for starting negotiations on a Stabilization and Association Agreement (SAA).

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<sup>1</sup> The new Constitutional Charter of the State Union of Serbia and Montenegro became effective on February 4, 2003, and as a result, the Federal Republic of Yugoslavia changed its name to Serbia and Montenegro as of that date.

2. The PRSP for Serbia and Montenegro (SAM) comprises a union-level overview and a PRSP for each of the two republics.<sup>2</sup> It builds on the Interim PRSP for the Federal Republic of Yugoslavia presented to the Boards of the International Development Association and the International Monetary Fund (IMF) in August 2002 (Report No. 24490-YU and EBD/02/118, 7/24/02). The Montenegrin PRSP is broadly in line with the Agenda of Economic Reforms, the key government document setting priorities. The Serbian PRSP is also broadly consistent with other Government strategies and plans, including “*Serbia on the Move*,” a document presented at a donor coordination meeting in November 2003. The republican strategies share many strengths. They:

- support macroeconomic stability and market-oriented reforms;
- through the Stabilization and Association Process (SAP), look to *harmonization with EU standards for trade* and other areas; and to *eventual accession to the EU as well as WTO membership*;
- are based on strong *poverty diagnostics*;
- affirm the continuation of the *privatization of financial and productive assets*;
- envisage *improvements in the business environment* to facilitate private investment and growth, including judicial and legal reform;
- emphasize that the most *critical poverty is in rural areas* (southeastern Serbia, northern Montenegro), and among excluded groups (Roma, IDP, refugees, disabled), and pledge to do more for these vulnerable groups;
- are based on *extensive consultation*—both republics established comprehensive frameworks and collaborative partnerships with NGOs;
- *emphasize employment-generation programs*, especially for small and medium-sized enterprises (SMEs), with Serbia in particular allocating considerable amounts for SMEs;
- focus on improved *social protection*, and better targeting of programs in health and education;
- include a set of *goals, which are quantified and linked to the Millennium Development Goals (MDGs)*; and
- contain *costed programs*, which place the bulk of the spending in education, employment, health and social protection.

Key areas for improvement include:

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<sup>2</sup> The individual PRSPs contain detailed policy matrices indicating the timeframe for implementing reforms in various areas.

- the Serbian PRSP is up-front on the issue of *crime/corruption*, while this issue is barely mentioned in the case of Montenegro despite its prominence in the consultations;
- the Montenegrin PRSP has an extensive discussion of *infrastructure* needs, while the discussion of this issue in the Serbian PRSP is limited;
- the Serbian PRSP provides an extensive analysis of the links between *agriculture and rural development and poverty*, which is missing in the Montenegrin document;
- both reports are excessive in length and coverage of topics, rendering it difficult to assess how priorities have been determined. Inter-sectoral prioritization emerges more clearly in the costing tables. Intra-sectoral prioritization is less clear;
- the estimates of *poverty program costs for 2004–06* are inconsistent and, especially for Montenegro, excessive (€400 million for Montenegro equivalent to 9 percent of GDP per annum, compared with €1.1 billion for Serbia, equivalent to about 2 percent of GDP per annum);
- *financing plans for poverty programs* are vague and somewhat unrealistic. Serbia's plans are vague, while for Montenegro 60 percent of the costs are assumed to be covered from foreign sources, although this would mean an additional resource transfer equal to 5½ percent of GDP annually. The Montenegrin PRSP lists an additional set of electricity and other infrastructure projects that are not in the PRSP program and would be undertaken if financing were available, over a longer period if needed. While some of these projects might be undertaken by private investors, their inclusion confuses the sense of priorities;
- *plans for institution-building and PRSP implementation* will require further elaboration. The governments must ensure that sufficient financial, advisory and technical support is available to support PRSP realization. This is critical both in Serbia with the recent changes of government and in Montenegro where capacity is thin and stretched.

## II. PARTICIPATORY PROCESS

3. The SAM PRSP is based on an extensive and inclusive consultative and participatory processes. A partnership with Catholic Relief Services serving as an NGO umbrella coordinator was established to facilitate dialogue and develop the strategies. Although the institutional structures set up by each republic to oversee the PRSP development were large and complex—involving the governments and numerous representatives of civil society, the business community, local governments, and academia—they proved quite workable. A series of consultations were organized over the year. Parliamentary committees were actively engaged in both republics (although only in the later stages in Serbia). Both republics also engaged in formal dialogue with labor unions, a unique undertaking in Serbia and

Montenegro's history. Sustaining these important channels of communication will be a key challenge for PRSP implementation.

4. The PRSP process, through its high visibility, has succeeded in raising awareness of the scope of poverty and its dimensions. As a result, there is a new openness to discussion of formerly sensitive topics in both republics, which the PRSP summarizes well. For the first time, statistics on poverty were available to public scrutiny and dialogue. It will be important to ensure that statistics are accurate and accessible and that the government continues discussing them in public fora as PRSP implementation continues. In Montenegro, the PRSP has played a limited role in raising issues of corruption and governance to national and local audiences. In Serbia, where the creation of a national Anti-Corruption Council preceded the PRSP, the PRSP opened the dialogue to a broader group of constituents. It is hoped that, as the PRSP implementation is realized, there will be greater candor about corruption and governance, with more sustained and tangible attention paid to these crucial issues. Finally, building on the strong participatory approach to date, as the PRSP is realized, sustained dialogue with stakeholders will be necessary in order to maintain momentum, manage expectations and strengthen understanding of, and commitment to, common goals.

### **III. POVERTY DIAGNOSTICS**

5. The poverty diagnostics in the republican PRSPs are well done, sharing a number of common strengths. Both present a detailed poverty analysis based on representative, recent, and technically sound data. This represents impressive progress since the I-PRSP, for which no reliable data on poverty were available. Both strategies exhibit solid analysis of the vulnerability of specific groups—poorly educated individuals, rural population, elderly, children, large households, unemployed, disabled, IDPs and refugees, Roma—and regional dimensions of poverty. Poverty profile findings are used in the development, justification and prioritization of policies proposed in the PRSPs. The data collection and analysis were truly participatory and open processes with technical assistance from the World Bank and other donors.

6. As the PRSPs are implemented, it will be important to maintain the positive momentum in poverty analysis while addressing new issues, such as the links between poverty and public expenditure allocations, integration of qualitative data in the poverty diagnostics, and poverty and social impact analysis of on-going reforms. This work will be supported under the Poverty Assessment Program of the World Bank and by technical assistance from other donors.

7. In addition to common strengths, the PRSP for Serbia provides a concise policy-focused summary of the causes of poverty. It offers consistent poverty projections linking the future evolution of poverty with specific macroeconomic scenarios. The analysis provides a coherent framework for strategic choices, such as emphasis on economic growth, job creation and upgrading of human capital, more efficient social protection, a more decentralized approach to development, and the targeting of the marginalized groups with focused interventions. The strategy pays attention to inequality in well-being and provides in-depth

analysis of its level, sources and implications. It offers a fully integrated analysis of social protection and poverty, with a thorough assessment of coverage and options for reform. The Serbian PRSP distinguishes between factors of rural and urban poverty and links poverty with the state of infrastructure and housing. Finally, the PRSP offers a detailed analysis of the particularly high poverty in southeastern Serbia.

8. For the first Progress Report, the Serbian strategy should encompass: (i) follow-up work on risk and vulnerability (using the 2002–03 Survey of Living Standards of the Population panel data); and (ii) full integration of the marginalized groups (IDPs, refugees, Roma) into the poverty profile using the most recent data.

9. Montenegro's PRSP has a number of strong aspects in addition to general strengths mentioned above. These include: (i) a solid, fully integrated poverty profile, with IDPs, Roma, and refugees represented, using the most recent data (June 2003); (ii) detailed and disaggregated (by gender, region, factors of vulnerability) multidimensional indicators of poverty, including health, housing, education, social inclusion, with the document making a serious attempt to integrate human rights and discrimination issues into the poverty diagnostics; and (iii) collaboration between the Government and NGOs in poverty diagnostics with NGOs taking the initiative and filling the official data gaps.

10. As the Montenegrin PRSP is implemented, attention should be paid to: (i) strengthening prioritization of the poverty profile findings and links of the poverty diagnosis with the strategy and priorities; and (ii) providing analysis of environmental aspects of poverty (with environment being one of the key priorities of PRSP) in the set of multidimensional indicators of poverty. The programmatic Poverty Assessment work, with donor support, will produce such indicators and propose the mechanism for monitoring.

#### **IV. POVERTY REDUCTION STRATEGY**

##### **A. Macroeconomic Framework**

11. Serbia's macroeconomic framework is consistent with sustainable growth and the authorities' poverty reduction goals, while achievement of the same objectives in Montenegro would require stronger fiscal consolidation than currently envisaged. Both PRSPs include appropriately ambitious macroeconomic objectives: real GDP growth of 3–5 percent per annum through 2010, inflation convergence toward EU levels, and a narrowing of the external current account deficit, in line with the program supported under the IMF's 2002–05 Extended Arrangement. A key component of the policy strategy in Serbia is fiscal adjustment, supported by prudent monetary and wage policies geared to containing the growth in domestic demand while stimulating investment and exports. In Montenegro, the policy framework should envisage stronger fiscal adjustment, in line with available nonconcessional foreign financing, with a view to freeing financial resources for the private sector and safeguarding external competitiveness. In addition, some assumptions in the macroeconomic frameworks of both republics—notably the rapid rise in Serbian domestic

savings, large increases in foreign financing in Montenegro, and sustained high FDI inflows in both republics—appear optimistic.

12. Strict policy implementation will be essential if macroeconomic stability and the poverty reduction goals are to be achieved but will face important challenges. In part owing to new poverty reduction programs—which in some instances have not been adequately costed and aligned with the budgets—fiscal adjustment in both republics will hinge critically on strict prioritization in sectoral programs, efficient targeting of social spending, aggressive cuts in subsidies, a streamlining of personnel costs, growth-oriented tax policy reforms, and further improvements in tax administration. In Montenegro, the use of the euro as legal tender raises the importance of prudent fiscal policy, wage discipline, and resolute structural reforms in achieving the poverty reduction goals. With external debt service scheduled to rise in the coming years with the expiry of grace periods under obligations to official creditors, it is important that both republics increase further their official reserves to guard against possible shocks while ensuring fulfillment of international financial obligations.

13. The continued support of the international community is important for the success of the authorities' policy efforts. The macroframework relies heavily on foreign financing to support poverty-reducing reforms and finance much-needed public investment. While the projected financing is in line with donor indications in November 2003, it has not been pledged yet, pointing to significant risks to the strategy. In the event of a shortfall in financing, the Government would need to follow tighter fiscal policy which may have an adverse impact on economic activity in the short-run. To ensure medium-term debt sustainability, the authorities must continue to follow prudent debt management policies, obtain debt relief from private creditors on terms comparable to those secured from the Paris Club, and implement structural reforms to boost productivity and FDI. Moreover, support from the international community needs to be largely on concessional terms.

## **B. Structural and Sectoral Policies**

### **Social Sectors**

14. In *health*, both republican PRSPs: (i) highlight the relationship of poverty and vulnerability with health and access to health care, drawing on recent household survey data; (ii) acknowledge data limitations and commit to the development of improved and regularly collected data; (iii) highlight the relationship of economic performance and general social conditions with access to the health system and its quality; (iv) draw out important intersectoral linkages; and (v) acknowledge that HIV/AIDS prevalence may be much higher than available statistics indicate and could rise further, and commit to combat the spread of the disease.

15. Most measures in the strategies are intended to enhance efficiency in the health sector rather than target the most vulnerable. Mechanisms to reduce barriers to access (such as informal payments, and corruption) and redistribute resources need to be elaborated. It will be important to embed such measures in the budget process and to monitor public and private

expenditure since progress would involve a reallocation of public expenditure and a reduction in out-of-pocket payments for basic health care, particularly by the poor and vulnerable. The PRSPs acknowledge the problem of direct payments, corruption and bribes but do not include specific measures to tackle these problems.

16. With respect to *education*, the PRSPs for both Serbia and Montenegro appropriately stress the relationship between poverty and education, and call for better targeting of resources on disadvantaged population groups. There is a well justified focus on pre-school education, which currently serves only urbanized and relatively affluent populations, and on adult training, which is important in view of the large, disproportionately poor population without marketable skills. The strategies acknowledge that many secondary programs lack relevance to the demands of the economy but the relationship between types of secondary education and poverty is not addressed adequately. Both papers propose useful indicators for monitoring poverty reduction through education, although more work needs to be done to set benchmarks for some indicators.

17. The Montenegrin and, to a lesser extent, the Serbian PRSPs, support a model in which secondary programs should provide specialized skills on the premise that the demand for them can be predicted, rather than general skills, competencies and learning tools which would allow children to adapt to a dynamic labor market. As the PRSP is realized, some discussion of potential efficiency gains in secondary education will be needed. Success in achieving the PRSP goal of increasing secondary enrollments and secondary completion will significantly expand demand for higher education, pointing to the need to deal with inefficiency and repetition in higher education as a priority. The Serbian PRSP acknowledges problems with the relevance and efficiency of higher education, but the Montenegro paper does not. There is limited discussion of financial constraints, the financial sustainability of proposed policy measures, as well as and the lack of efficiency as a constraint to introducing pro-poor measures in education. This is particularly problematic in the education sector for which the largest single funding request has been made for support in both republican strategies. Questions on the financial sustainability of the proposed recurrent expenditure and the capacity to expand and improve the system rapidly should be addressed in the first Progress Report.

18. The *social protection* sections of both republican PRSPs make excellent use of the available data, and support the policy recommendations in the analysis. The Montenegrin PRSP integrates the results of the recently completed survey of Roma, Ashkali and Egyptians. In Serbia, a household survey on Roma has just been completed. Its findings will inform PRSP implementation. Both republics accurately describe the reform challenges for the pension systems and the need to advance the systemic reforms outlined in the recently passed pension laws. The labor market discussions also correctly identify the constraints to employment growth.

19. The discussion of specific strategies to address poverty and expand opportunities for vulnerable groups, including Roma, IDPs and refugees are underdeveloped in both documents. For both republics, the new household data sources which were completed in Fall

2003 should provide the basis for further refinement during implementation. Coordination between implementation of the PRSP and the new federal strategy for Roma should be a priority. In the case of Montenegro, further analysis of benefit incidence and the impact of these benefits on living standards would be important to assess whether benefits contribute to poverty reduction. More reliable unemployment data can be obtained from the Montenegro labor force survey (11.9 percent in 2002) and from the living standards survey (8.4 percent), than the official registration data cited in the text. In the case of Montenegro it is unclear how arrears in social transfers will be addressed.

### **Private Sector Environment**

20. The PRSPs rightly emphasize that improvements in *the business environment* are key preconditions for sustainable private sector-led growth. The strategy for Serbia acknowledges the need for streamlining the registration process, reducing administrative barriers to business operation, improving corporate governance, and establishing a modern bankruptcy regime. Likewise, the Montenegrin authorities should build on their early progress in the area of business entry and operation by further streamlining the rules and procedures for getting licenses, decreasing waiting time and removing inconsistencies among procedures. In both republics, the authorities are encouraged to focus on building adequate institutional capacity for implementation of the new regulatory framework. In particular, high priority should be given to the *reform of commercial courts* in order to ensure the protection of property rights and enforcement of contracts. The authorities are also encouraged to build on their commendable early progress in the area of *enterprise privatization* by accelerating the restructuring and subsequent divestiture of large problematic socially- and state-owned enterprises. The restructuring process could be greatly facilitated by the creation of an effective mechanism for debt workout that would minimize moral hazard and involve all major state and state-controlled entities.

21. Comprehensive reform of the *financial sector* represents an important cornerstone of governments' growth strategies. For Serbia, the PRSP correctly identifies the short- to medium-term actions needed to strengthen bank supervision, restructure and privatize remaining state-owned banks, and develop efficient capital markets. With proper implementation, these reform steps should help significantly in allowing the Serbian financial system to play its proper role in channeling resources into productive investments. The timing and modality of bank privatization would directly affect the authorities' ability to attract the much needed capital and technical know-how essential for building a robust banking sector. The PRSP also notes the importance of expanding the coverage of microfinance programs, given the vital role of micro and small enterprises in Serbia's economy. Nonetheless, there is an undue emphasis in the PRSP on improving access to credit through government-sponsored institutions (e.g., Development Fund, Guarantee Fund), while more attention could be given to improving financial infrastructure (credit bureaus, collateral legislation) to allow banks to cater to business needs more readily. The PRSP also lacks a well-defined agenda to develop non-bank financial institutions, including the development of an effective insurance sector. For Montenegro, the strategy emphasizes the necessary instruments for lowering and standardizing interest rates, introduction of the deposit

insurance scheme, closure of the Office for Payment Operations, reform of the government treasury operations system, and adoption of a comprehensive regime for prevention of money laundering. In fact, Montenegro has taken a number of important steps in most of these areas as well as in restructuring and privatizing the banking sector. Key next steps should include: finalizing privatization of the remaining state-owned bank, withdrawing Government deposits from the commercial banks, and resolving bad assets carved out of privatized banks.

22. The Serbian strategy extensively diagnoses rural poverty patterns and appropriately links them to alleviation measures. Its balanced emphasis on both *agricultural and non-farm rural development* is welcome, especially as integration with the regional, European and world economies will increase competitive pressures on agriculture, and require increases in agricultural productivity, including integration of poorer farmers into the market. The consequent exit of some farmers from agriculture will also create the need to improve prospects for rural non-farm activities. In implementing the Serbia PRSP, additional emphasis could be given to specific investment activities that would raise farm productivity, such as irrigation, extension, and land market development. Completion of farm privatization is an important step toward increased growth. The Montenegro strategy lacks a rural poverty diagnosis and its limited discussion of rural development is almost entirely focused on agriculture rather than non-farm activities. For these reasons, it is not clear how the actions mentioned in the section of the strategy, and the significant resources envisaged to finance agriculture-related activities, will reduce rural poverty.

### **Infrastructure**

23. In *energy*, as the PRSP notes, Serbia needs to move to a more cost-reflective tariff structure. To this end, the current first block in the block tariff structure will be reduced and offsetting measures will be taken to improve the targeting of subsidies. For Montenegro, there is a need to introduce a power sector social safety net to support poor groups in society. In this regard, monitoring of power affordability will provide the basis for designing a targeted subsidy, perhaps by introducing a block tariff for an interim period or through targeted subsidies. The *water sector* strategies of the Governments of the Republics of Serbia and Montenegro appropriately take into account the needs of the poor and address the main challenges the sector is facing. During the implementation of the PRSPs the programs need to become more specific in addressing these challenges and it is expected that the monitoring of the service delivery to the poor, especially in rural and semi-urban areas, will help to further define the programs for the water supply and sanitation sector. Such efforts will contribute towards the attainment of environmental Millennium Development Goals. In *transport*, the strategies appear to understate the importance of the road transport sector in infrastructure investment. In addition to efforts to improve the operations of railways, ports and marine transport and rural roads, the condition of the main and secondary road networks also require considerable improvement. As the PRSPs are implemented, more attention needs to be given to the role of *information communications technologies* (ICT) as the sector has not made its full contribution to poverty reduction and the development of Serbia and Montenegro. This is particularly important given the significant disparities in access to ICT between rural and urban populations and between costs and prices charged.

24. The republican PRSPs appropriately link poverty with *environmental and natural resource management* concerns. They emphasize the need for sustainability of natural resource use, noting that environmental and natural resource degradation do not occur in isolation and have to be considered as part of any policy and investment intervention that aims at economic growth and poverty reduction. As PRSP implementation is realized it will be also important to monitor: (i) public health risks posed by industrial pollution (air, soil and water); (ii) health risks faced by the Roma from scavenging municipal waste which often contains hazardous industrial and medical waste, in addition to lack of utility services; and (iii) the potential impact on forests through increased cuts for fuel wood as a result of energy price increases. Both PRSPs also appropriately emphasize the need to improve the legal framework and its enforcement and build institutional capacity. While both strategies identify priority actions, in Serbia only some of them were included in the costing. As shown by the experience of EU candidate countries in Eastern Europe, even a gradual harmonization with EU standards will require a significantly higher commitment of budgetary resources.

#### **Public Administration Reform (PAR), Governance and Corruption**

25. The Serbian PRSP reflects the approach and stated priorities of the government towards *public administrative reform*, on which there is broad agreement among the reformist political parties. Priorities include the rationalization of the structure of the state administration and the reform of incentive systems to reflect European best practice, with particular emphasis on (i) reforming the overly complex pay system in the state administration, (ii) modernizing the legislation governing civil service and public administration management, and (iii) improving the policy management system, in particular by strengthening the capacity of the Government Secretariat. A comprehensive strategy and action plan for reform are under discussion. Altogether, these measures should create a slimmed down and more competitive system of public administration. The objectives and actions are generally well captured in the matrix and are appropriate to achieving these objectives. However, the related policies/strategies matrix column does not make reference to the actual adoption of the strategy and action plan on PAR, even though its principles are well reflected in the actual PRSP. This is a missed opportunity. In the implementation and monitoring phase, the objectives and outcome targets should contain a specific reference to the creation of a merit-based and impartial civil service.

26. Montenegro's significant progress on many PAR related issues is not done full justice in its PRSP. Montenegro has adopted a comprehensive PAR strategy and has over the last year adopted several key pieces of legislation on Public Administration, and also has started the process of rationalizing administrative structures. The Montenegrin strategy would benefit from a similar matrix with specified policy actions to make the document more concrete, and allow the effective tracking of PAR implementation.

27. As noted, the consultative process was particularly useful in putting the subject of *governance and corruption* into the public arena. However, despite this progress, the

strategies do not address these issues frontally. Given their importance to the revitalization of the economy, greater attention will need to be paid to these issues during PRSP realization.

## V. COSTING, IMPLEMENTATION, MONITORING AND EVALUATION

28. **Costing.** The authorities have made considerable efforts to begin to cost the PRSP programs but this is clearly still a work in progress, especially in Montenegro. Both strategies give preference to education, health and social protection and, in the case of Serbia, also to SMEs. Montenegro has a much larger allocation for agriculture and rural development, despite the relatively weak discussion on this part of the strategy (some of these funds, however, are for paying rural pensions). Nonetheless, in general, program costs are inconsistently derived and in some instances, appear excessive. Tables in both documents include some measures that are not discussed in the text.

29. Beyond costing, the PRSP programs will need to be increasingly aligned with the budget process. Serbia has initiated this process in the FY04 budget but much work remains to be done to fully integrate the process, including: (i) further elaboration on the link between the envisaged budget allocations and the policy priorities; and (ii) identification of specific policy actions along with target dates for their implementation within the priority PRSP sectors. Montenegro should undergo a similar process of prioritizing and sequencing reforms consistent with medium-term fiscal consolidation and with realistic assumptions on foreign financing. The Bank may provide additional technical assistance in this area to both republics over the coming year.

30. **Implementation.** While significant organizational infrastructures were established, some with donor support, for the development of the PRSPs in each republic, plans for their institutionalization are not fully developed and capacity constraints are serious. Both republican strategies will need to devote considerable attention to strengthening plans for implementation and sustaining the requisite institutions and channels of communication. This is all the more critical given that there have been personnel changes in both governments. It will be important for the new Serbian Government in particular, to reaffirm its commitment to the principles of the PRSP and to take on its implementation immediately. As external financing for PRSP development comes to an end in Montenegro, the government will need to ensure adequate financial and institutional support for its implementation. Finally, public expenditure management needs to be enhanced in both republics to support effective PRSP implementation.

31. **Monitoring and evaluation.** The setting of achievable and measurable outcome benchmarks aligned with MDGs receives adequate attention in the PRSPs, with baseline data provided for all selected indicators. This represents commendable progress since the I-PRSP and reflects a cross-sectoral effort and collaboration by government agencies and NGOs. The PRSPs provide few details on how the Government is planning to improve administrative data within key programs directly impacting the welfare of the poor. This issue will need to be discussed in the first Progress Report. Public access to data (including survey data) should be explicitly mentioned as a key element of the participatory process for monitoring the

PRSP, and needs to be treated seriously in PRSP implementation to foster transparency and broad acceptance of the findings. The strategies offer a wide range of indicators but few details are provided on plans to carry out evaluations or Poverty and Social Impact Assessments of the policy actions and programs. There is also only limited focus on public expenditure incidence analysis and impact assessment. These issues will need to be addressed during implementation and discussed further in the Progress Reports.

32. In the area of monitoring and evaluation, the strengths of the Serbian PRSP include: (i) justification for core indicators, and explicit and clear alignment with EU Accession agenda and MDGs; (ii) plans to produce core indicators disaggregated by region, household type, gender, age and vulnerability characteristics; and (iii) a detailed M& E institutional set up including budgeting. However, it also shows: (i) a lack of prioritization among 160 process indicators (input and outcomes) monitored through sectoral systems; and (ii) development and reporting of target values only for some key indicators (such as poverty rate or GDP growth rates). During 2004, this should be refined and improved with results to be discussed in the Progress Report.

33. The Montenegrin PRSP presents indicators that appropriately include key data related to public expenditure. However, the strategies lack discussion of the institutional arrangements for monitoring and evaluation and do not provide costing for producing indicators and monitoring them, while financing arrangements are vague. The strategies also fail to specify a feedback process through which monitoring and evaluation results will be disseminated and used to decide future courses of action. It would be important to know more details on the ongoing reform of the official household survey (HBS) and targets related to the transfer of poverty indicators from MONSTAT. These aspects could usefully be detailed in the first Progress Report.

34. **Support for the PRSP.** The World Bank Group, with support from the IMF and other donors, has launched a number of initiatives and events to support PRSP development in SAM. Serbia and Montenegro each received grants from DFID (UK) and the Multi-Donor Trust Fund administered by the Bank to support PRSP development. The Governments are developing a proposal for a second tranche of the Multi-Donor trust fund to support PRSP implementation. The Bank, together with other donors, notably DFID, the EU, Sweden (SIDA), the Netherlands, Eurostat TA, the EC Food Security Program and the UNDP, is helping to improve the collection of statistics and develop capacity-building training programs in Serbia and Montenegro. The IMF is also providing continuing technical assistance for improvement in statistical methods. The Serbian Government, the Republican Statistical Office, the World Bank and SIDA plan to organize a joint workshop in 2004 on statistical capacity for monitoring poverty. The multi-year programmatic approach to the Bank's poverty work in SAM helps to ensure that the results of the poverty analysis and monitoring are used in the process of policy making. A number of analytical papers, including the SAM Poverty Assessment and republican poverty notes have been completed and others are in progress. A regional PRSP workshop and a regional training of trainers seminar were organized by the World Bank Institute (WBI) in Baden, Austria and Budapest, Hungary. Bank staff organized workshops on poverty-environment linkages in each republic.

The Bank, the Fund and the UNDP plan to organize another regional Poverty Forum in Spring 2004. In-country courses on Poverty Analysis for policymakers, researchers and NGOs are also being offered and capacity building initiatives for stakeholders, including Roma, are also underway.

## VI. RISKS TO THE STRATEGY

35. Successful implementation of the Serbia and Montenegro PRSP is subject to external and, especially, domestic risks. Although persistence of weak economic activity in key trading partners would dampen export growth and private capital inflows, more serious concerns center on the domestic front. More specifically, against the background of modest output and export growth and a fragile external position, failure to achieve high quality fiscal adjustment and deepen the structural reform process could leave SAM vulnerable to adverse shocks and undermine its ability to attain the PRSP objectives. Sustained fiscal adjustment will require challenging policy actions, including to control the public sector wage bill, subsidies, and transfers. Maintaining momentum on structural reforms will also entail difficult decisions, especially in restructuring the banking and enterprise sectors, as well as good progress in implementing the Action Plan on Harmonization and other measures to support integration with the European Union..

36. Following the December 28, 2003 parliamentary elections, Serbia is in the process of forming a governing coalition committed to reform and the PRSP priorities<sup>3</sup>. As soon as the coalition is formed, it will be critical that the new Serbian government take quick and decisive steps to initiate PRSP implementation and to ensure its sustainability through the budgetary and consultative processes. Montenegro also needs to move more decisively on its reform agenda. As evidenced in the December Serbian election, reform fatigue backlash continues to be a concern; however, the depth of the reforms makes a backward movement increasingly unlikely. At this crucial juncture, the governments need to sustain strong policy performance and to further strengthen popular support for the reforms by maintaining the dialogue and keeping the commitments established with the public during the PRSP development process. This would also facilitate continued support from the Bank, the IMF, and other donors.

37. Implementation capacity remains a major weakness and concern. Following adoption of the constitutional Charter in 2003, SAM is just initiating multi-year programs to build the necessary institutions. Implementation of the PRSP will thus in the short term present additional complexities and burdens for the governments. Strong government commitment is essential, but it alone is insufficient. Technical assistance and continued support from the donor community, particularly in costing, budgeting, monitoring and evaluation, will be vital

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<sup>3</sup> Discussions with key democratic block party leaders who are expected to form a governing coalition were held in Belgrade during January/February 2004. Party representatives reaffirmed commitment to the PRSP approach.

to the ultimate success of PRSP realization. The World Bank Group and the IMF intend to provide continued support for PRSP implementation.

## **VII. CONCLUSION**

38. The staffs of the IMF and the World Bank consider that the Serbia and Montenegro PRSP provides a credible poverty reduction strategy and recommend that the Executive Directors of the IMF and World Bank reach the same conclusion. Bank staff further conclude that the PRSP represents an adequate basis for World Bank support and recommend that the Executive Directors of the World Bank reach the same conclusion.

**Poverty Reduction Strategy  
of the  
Union of Serbia and Montenegro**

Introduction

The Union of Serbia and Montenegro was formed in February 2003 following the signing of the Belgrade agreement in March 2002, out of the remaining parts of the former Socialist Federal Republic of Yugoslavia. The union of these two republics helped conclude a difficult period of wars, international sanctions and international military intervention which led to destroyed infrastructure and social and economic decline. There was a dramatic reduction of GDP by more than 50%, massive increase in unemployment, a drastic fall in salaries, pensions and other personal income caused by the politics of the previous authoritarian regime. Hundred of thousands of people came as refugees and IDPs, fleeing their traditional homes in search of a place to live without fear of ethnic reprisals. There was a general increase in crime and corruption, and a rapid growth of the “grey” or informal economy. All this led to the rapid impoverishment of the majority of the citizens.

Against this background, the Governments of the Union and both republics, during the last years have made major economic and political reforms, and have begun to address the problems of poverty and social exclusion. We have made major efforts to move from the socialist to a market-based economy, while moving at the same time to a democratic political structure. Economic reforms have included major privatisations of productive and financial assets, liberalization of the trade regime, reform of the social security system, judicial reform, and liberalization of labour laws. In general, steps have been taken to improve the environment for business by reducing unnecessary bureaucratic regulations and taxes. Discussions have begun that will eventually lead to the membership of Serbia and Montenegro in the WTO and the EU. These reform efforts began in Serbia only in 2001, with the emergence of a democratically elected republican government, but started somewhat earlier in Montenegro.

An Interim PRSP was discussed by the Boards of the IMF and World Bank in July 2002, and was prepared over the period during the negotiation process of the creation of the new union of the two republics. Thus, the I-PRSP gave only a vague sketch of our emerging poverty strategy. The current document represents the overall final poverty strategy for the union of the two member states, being composed of separate PRSPs each for Serbia and Montenegro.<sup>1</sup> Both papers analyse the latest available data on poverty, reflect challenges facing the governments in addressing the acute poverty situation and lay out policies and mechanisms for the sustainable reduction of the poverty over the medium term. The strategies adopted by the individual republics are consistent and form an overall strategy for the State Union.

A successful implementation of the Poverty Reduction Strategy will mean a reduction of poverty in the Union of Serbia and Montenegro to around 7 percent by 2010 with an average annual growth of around 4–4,5 percent and the same level of average inequality in society.
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<sup>1</sup> In Montenegro, the strategy is entitled Development and Poverty Reduction Strategy or DPRS.

## The Poverty Situation

The Governments recognises that poverty is a multidimensional economic, social and phenomenon, which crucially depends on incomes and employment opportunities as well as, social inclusion, access to education, health, quality of housing and other public services. Participation in social and political processes, protection of human rights, gender and ethnic equality are essential dimensions of a wider poverty definition. With such broad definition and limited resources the choice of priorities and the design of effective and targeted public actions gain critical importance in reaching the necessary balance between longer and shorter term needs and challenges.

Poverty analyses show that poverty in the Union, at about 11%<sup>2</sup>, approximately 800.000 in Serbia and 87.600 in Montenegro lives below the national poverty lines with consumption (per equivalent adult)<sup>3</sup> of less than 71 € per month in Serbia and 116.2 € in Montenegro, i.e. 2.4 € and 3.9 € per day.<sup>4</sup> Poverty is higher among vulnerable groups and in rural regions. Additionally in both Republics, many people are at risk of falling below the poverty line. Small changes in average income and external shocks would produce large changes in the poverty rate. For instance, in Serbia, a 22% fall in real income would double the poverty rate. In Montenegro raising the poverty line with 20 percent will double the number of poor.

In the rural regions of both Serbia and Montenegro, poverty is much higher than average. In northern Montenegro, poverty rates average 19%, while in southeastern Serbia poverty is estimated at 23%. Poverty is generally clearly correlated with a number of factors:

- unemployment,
- low levels of education,
- large family size,
- single-member and elderly households, and
- vulnerability.

The highest rates of poverty, however, are found among certain vulnerable and socially excluded groups, including displaced persons, refugees, the disabled, and the Roma population. Within the Roma<sup>5</sup> population, a recent survey in Montenegro found that 52% lived in poverty, they have an unemployment rate of 43%, and 70% have not attended secondary school. It is estimated that there is 32% illiteracy. According to official statistics there are around 120,000 Roma living in the Union territory but domestic and international estimates indicates that the actual number is around 370.000. In addition, according to the most recent estimates, there are over 600,000 refugees and IDPs<sup>6</sup> living in Serbia and Montenegro, who have severe deficiencies in housing, employment, health and education. According to assessments, around 22% percent of this category lives in poverty.<sup>7</sup> Another vulnerable group is the disabled.

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<sup>2</sup> Poverty headcount estimates are 10.6% for Serbia in 2002 and 12.2% for Montenegro in 2003. However, poverty estimates for Montenegro include Roma population and a larger portion of Refugees, which are excluded from the estimates for Serbia.

<sup>3</sup> Consumption per equivalent adult allows for the differences in the consumption of adults and children as well as for the joint costs of the households.

<sup>4</sup> 4 rate 63.225 dinars per €

<sup>5</sup> Technically RAE: Roma, Ashkaelia and Egyptian minorities. Internally Displaced Persons.

<sup>6</sup> Internally Displaced Persons.

<sup>7</sup> In Montenegro 38 percent and in Serbia 25 percent of Refugees and IDPs lives in poverty.

Although there are no precise figure, some estimates indicates that there are approximately 360,000 disabled in the Union. Only 13% of the disabled have the opportunity to work, and only one-third have a job adjusted to their needs.

The PRSP process in both republics included extensive consultations with all relevant stakeholders through established advisory committees (Civil Society, Parliamentary, Local Government, Media, Labour Unions, Experts, International Development Partners and Business sector). In these consultations, the problems faced by the poor were revealed. While each group often had different priorities, these discussions placed heavy emphasis on a few key factors; employment, rule of law, public services including infrastructure, health and education, housing and social services.

### Poverty Strategy

Integration into the EU is the strategic objective of the Union of Serbia and Montenegro. Consequently, the development of the society and the economy including the fight against poverty in Serbia and Montenegro is pursued with European values, EU norms and standards, as well as EU policies in mind.

Through the process of developing the Poverty Reduction Strategy, national indicators in line with the UN Millennium Development Goals (MDGs) have been identified. Hence, we have taken an important step forward in the process of reaching these goals by 2015.

Our overall poverty reduction strategy for the Union consists of three main pillars:

- establishing the conditions for dynamic and equitable economic growth, through the creation of a stable macro-economic environment and favourable investment climate, that will create employment and reduce economic vulnerability, as well as the establishment of key programs to directly promote employment among the poor;
- prevention of new poverty resulting from the modernisation and restructuring of the economy through targeted training and social measures enhancing this group's ability to take advantage of new opportunities created in the reformed market economy.
- improved access to social services by the poor, such as health, education, water and other key infrastructure needs, through improved targeting of existing programs, and actions that improve the efficiency and quality of services delivered, particularly to the most vulnerable groups in society. The goal of these activities is to initiate a long- term process of empowering vulnerable groups to move out of poverty, through the development of new market-oriented skills, and the provision of minimum standards of living.;

Additionally the Strategy call for the establishment of better systems for implementation of activities and for monitoring of key poverty indicators in close co operation and with active participation of all relevant governmental and non-governmental stakeholders.

### Key Implementation Measures

The Governments are fully committed to the implementation of this Poverty Reduction Strategy. It will require significant efforts on many fronts, both to extend and deepen the reform

efforts recently begun, and to undertake additional efforts in other areas. The principle directions of our efforts will be as follows:

**Integration.** During the recent period, Serbia and Montenegro has joined international economic and financial organisations including IMF, WB, UN, Council of Europe, negotiation regarding Partnership for Peace membership has started and we have taken some initial steps towards EU and WTO accession. Additionally we have been an active player in the development of the South East Europe Free Trade Area. This has created the basis for further integration of the Union into the Region, Europe and the wider world, with the aim of enabling faster economic and overall development. In August 2003. an Action Plan for the harmonisation of economic systems in Serbia and Montenegro was adopted. The plan aims at the creation of a common market and the removal of obstacles to the free flow of people, commodities, services and capital. Through the Stabilization and Association process (SAP) the EU has encouraged Serbia and Montenegro to prepare for full EU membership by working to achieve very high standards relating to the economy, the functioning of the rule of law, democratisation, and human rights. The Government will continue its efforts to speed up the above-mentioned integration processes that are so crucial to enhance the stability of both Serbia and Montenegro and the region.

**Macroeconomic stability.** The policies will be geared to support growth while narrowing the external current account deficit. Against the backdrop of relatively modest output and export growth, and a large current account deficit reflecting in part strong consumer demand, policies in 2004 will aim to strengthen external competitiveness while containing the growth in domestic demand and costs. The external **current account deficit** (before grants) is projected to narrow by 1/2 percentage point to 10.3 percent of GDP in 2004, and to decline steadily thereafter, as exports recover toward historical levels—reflecting improving domestic supply conditions and an upturn in foreign demand—and imports continue to be contained by the implementation of prudent policies. During 2004, the overall fiscal deficit including foreign financed projects will be targeted to decline to 3.8 percent of GDP. Growth in wage bills in state enterprises will continue to be limited to the projected rate of inflation. The Government recognises that stability is a critical condition for both economic growth and poverty reduction and is therefore fully committed to continue its efforts to achieve this.

**Economic Environment.** The Government will continue to maintain a stable macro economic environment, and take steps to increase the attractiveness of the economy for private investors, including improvements in the legal and judicial structures and assistance to small and medium scale entrepreneurs. The privatisation process will accelerate, particularly based on the limited restructuring of state/socially owned enterprises capable of being competitive in the market. The implementation of new Bankruptcy Laws will enable us to close down those enterprises that cannot be profitably restructured. A major tax reform has already reduced corporate taxation and implemented or will soon be implementing, a VAT. Further tax reforms will aim at simplifying and improving the system. Reform in the financial sector have already improved financial sector regulation and increased the role of the private sector. The privatisation of the remaining publicly owned banks are envisaged over the next three years.

**Public Sector.** The public sector will be strengthened through measures to improve budgetary, procurement and treasury functions. A major program of judicial reform is already underway, with the intention of bringing the judiciary up to EU standards. Public administration reform is one of the priority tasks for the future, both to increase efficiency and to reduce the opportunities for corruption. Corruption in the public sector both discourages private investors, and denies the poor access to essential services. The key will be the establishment of a

professional civil service, free from political interference, with clear guidelines on ethical issues. In Serbia, an Anti-Corruption Council has been formed, and a group of anti-corruption laws are expected to be passed by in early 2004. The Government of Montenegro will soon adopt the programme for combating corruption and organised crime as well as the strategy for combating illicit people trafficking. Another key part of public sector reform is to strengthen local government structures, and decentralize the delivery of services to local municipalities, working with local NGOs. The Government recognises that well- functioning legal institutions, and a government bound by the rule of law, are important to economic and political development, and represent an important precondition for private capital investments and economic growth. The importance of the rule of law is enshrined in the principles of the EU.

**Social Sectors.** In general, the PRS envisions a continued improvement in all social services, including pensions and social protection programs, building on recent reforms. While programs of social protection have recently been improved in terms of targeting efficiency and program operation, a major issue remains the clearance of arrears accumulated from the past, particularly in Montenegro. A major effort will be made to improve the targeting of these programs to all eligible groups, particularly the most vulnerable and excluded, who often fail to participate. Special programs will be set up to provide social protection for the elderly. In the area of pension reform, the Governments will consider to move toward the establishment of the remaining two pillars of the reform: private mandatory and especially private voluntary systems. In the health sec/or, one of the main issues to be addressed includes the financing of the health system. At present. the benefits provided far exceed revenues from wage taxes. This requires redefinition of what services will be provided, and how they will be financed. The system itself needs to improve its overall efficiency in the use of resources, and shift its emphasis more toward preventative and primary care. A major focus of PRS reforms will be to include vulnerable groups, particularly the Roma, IDPs and refugees within the system. Support of the International Community is needed to achieve this. Greater efforts will be made to promote better public health through health promotion. In education, the major challenge is to improve the quality of education, to increase attendance in pre-primary programs, and to include vulnerable and excluded groups. A major problem is that existing vocational secondary schools are not aligned with contemporary market demands. A major reform of the curricula, and better coordination with the private sector, is required. Special programs will be designed to make schools more accessible to the Roma population, and to children with special needs, particularly the disabled.

**Rural Development.** The high rate of poverty in rural areas necessitates special attention to the needs of these areas. These include steps to improve productivity in both farm and non farm employment, as well as improvements in social services and rural infrastructure. To do this requires efforts to help support development of SMIEs, improve marketing and processing facilities for agricultural goods, and better development of forest resources, especially wood processing. Special emphasis has to be given to rural infrastructure needs, including reliable water supply at EU standards, better sewer and sanitation services, and improvements in rural roads that allow access to markets. During the coming period the responsibility and the capacity of the local self-governments needs to be strengthened to achieve this.

**Infrastructure and Environment.** A major effort will be made in the PRS to improve basic infrastructure throughout the country. Much of the present stock of infrastructure has deteriorated during the last decade due to a lack of investment and adequate maintenance. There is a major need to rehabilitate the existing stock of infrastructure, and make limited extensions. This is particularly true in transport, where efforts need to be made to improve the operations of

the railways, ports and marine transport. A major effort needs to be made to improve the safety of road transport, as well as to improve roads in rural areas. In energy, major efforts have been made to improve reliability of power supplies, restore and rehabilitate key assets, and improve cost recovery. For the future, greater efforts will be made to improve efficiency and collections of bills, and to work more closely with private investors in rebuilding capacities. In water supply, the major goals will be to improve the efficiency, management and financial operations of service providers, to enhance the accessibility and quality of water services, and to protect human health and the environment. The PRS is based on the concept of sustainable development and rational management of natural resources. In terms of environmental management, we will focus on establishing the appropriate legislative and institutional frameworks, improve the environmental management system efficiency, and implement priority projects to reduce pollution and environmental degradation. Furthermore, it is critical to continue the strengthening of the capacity of involved institutions and companies, with the objective to improve planning and implementation of externally financed projects. In this context, it is important to shift away from a mainly technical-focused approach to one emphasising cost-benefit and economic analysis. It is also important to speed up the restructuring process within these sectors, in order to prepare the companies for privatisation and external competition.

#### The Cost of the PRSP

Both republics have undertaken detailed costing exercises to approximate the additional cost, beyond their present resources, needed to implement this Strategy. These costs are summarized in the table below, by sector. The overall cost for the period 2004–06 has an indicative total of € 1.5 billion (Serbia €1.1 billion, Montenegro € .4 billion). However, not all of these costs are additional, but would be partly met from reallocations within sectors and between sectors using currently available resources. In addition, some of these costs could be met from additional domestic resource mobilization. The balance would have to come from external assistance. In Montenegro, it is estimated that foreign financing would amount to about 60% of the total.

Table I. **Serbia and Montenegro: Breakdown of PRS Costs by Sector.**  
(millions €)

<b>Sector</b>	<b>Serbia</b>	<b>Montenegro</b>	<b>total</b>	<b>%</b>
Social Protection	157.2	54.7	211.9	13.9%
Education	333.2	96.7	429.9	28.2%
Health	170.2	47.4	217.6	14.3%
Employment	238.5	49.9	288.4	18.9%
Rural, Regional & Agriculture Dev.	64.3	64.9	129.2	8.5%
Environment	5.8	26.4	32.2	2.1%
Infrastructure/Urban	70.3	67.2	137.5	9.0%
Others	47.8	32.6	80.4	5.2%
total	1087.3	439.8	1527.1	100.0

While the PRS includes some spending for almost every sector, the priorities overall emerge from the greater weight given to certain sectors. The priorities clearly are education, employment, health and social protection, in that order. These four alone amount to 75% of the total. Priorities do differ slightly between the two republics, however, with Montenegro giving more weight to rural development and infrastructure, compared to Serbia.

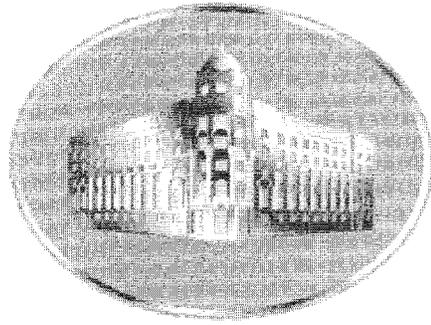
## Implementation. Monitoring and Evaluation

The fight against poverty is a long struggle that will be facilitated by the implementation of the PRS. To maximise the future impact of the strategy, it is important to ensure an effective integration with and linkages to the overall reform process and the overarching European Integration agenda. It is also of central importance to align and link the implementation of the PRS with the yearly Budget process and the framework external resources.

With the adoption of the Strategy, the focus shifts from planning to action - a critical and challenging phase for most strategy processes. It is now necessary to develop effective implementation mechanism taking into account available resources and constraints. The Government of Serbia and Montenegro is committed to doing so.

Each republic has established a set of goals for monitoring purposes. These targets are closely aligned with the Millennium Development Goals, and include both ultimate objectives and process indicators. The next important steps that are required will be to improve statistical capacities to report on these indicators, and to establish working groups in the relevant ministries to be in charge of monitoring not only the indicators, but also the actual implementation of the strategy itself. We intend to carry out the monitoring of the PRSP in a participatory fashion, actively involving all relevant stakeholders, including the civil society, and the Parliament.





**Government of the Republic of Serbia**

# **Poverty Reduction Strategy Paper for Serbia**

**Executive Summary and Activity Matrices**

Belgrade, 2003



“A national poverty reduction strategy must tackle the causes, not only the consequences of poverty; it should be defined as a strategy of social development, aimed in the long run at building a successful but fair society governed by principles of solidarity and equal opportunity for all.”

A handwritten signature in black ink, appearing to read 'Zoran Đinđić'.

*Zoran Đinđić, PhD*

Belgrade, 18 December 2002

Conference “Poverty Profile in Serbia”



# POVERTY REDUCTION STRATEGY PAPER FOR SERBIA

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## II ACTIVITY MATRICES



# POVERTY REDUCTION STRATEGY PAPER FOR SERBIA

## EXECUTIVE SUMMARY

### 1. Origins of Poverty in Serbia

Poverty, especially its extreme forms, was scarcely in evidence in Serbia until the beginning of the 1990s. Serbia, as a constituent part of the former SFRY, used to have a per capita GDP of more than 3,000 USD; it had developed commercial and financial relations with the West, and the economic system was largely based on market principles. Education, health care, social protection and other services were accessible to the majority of citizens. For these reasons Serbia, together with other former Yugoslav republics, was in a good position to make the transition to a modern market economy and a democratic society with much less difficulty than other countries in transition.

Instead, however, Serbia underwent a complete economic and social collapse in the 1990s, and the development of democracy remained at a standstill. There was a dramatic fall in GDP (of about 50%), massive unemployment, a drastic fall in salaries, pensions and other personal income caused by the policies of the previous authoritarian regime, international isolation of the country, strict economic sanctions, the breakdown of the market within the former SFRY, wars in the region, and the bombing of Serbia in 1999. The situation was additionally aggravated by the influx of 700,000 refugees and internally displaced persons from Bosnia and Herzegovina, Croatia and Kosovo, who now represent nearly 10% of Serbia's population.

All this led to the rapid impoverishment of the majority of citizens, and, on the other hand, to the enormous enrichment of a small group of people by means of corruption, economic crime and close links with the regime. The share of the "grey" economy during the unprecedented hyperinflation of 1993 exceeded 50% of GDP.

All this meant that the new democratic Government had to confront two equally difficult problems after the political changes in October 2000. On the one hand, it inherited the most difficult economic and social situation in which Serbia has found itself in its recent history. On the other hand, due to ten years of inaction, it was necessary to start immediately the crucial transitional and reform processes, in highly unfavourable circumstances. Many of these processes are painful, since they open up new social problems and emphasize new forms and areas of poverty, primarily as a consequence of the restructuring of the economy and the entire process of adjusting to the rules of a market economy and to international competition.

Finally, insufficient attention had previously been given to socially vulnerable groups (children, the elderly, persons with disabilities, refugees and internally displaced persons, Roma, the rural poor, and the uneducated) who are affected by the severest forms of

poverty. The reasons for this were above all financial, but also arose out of an attitude of ignorance towards the problems and the neglect of the basic human rights of these groups. Much more has been done in this area since the democratic changes in 2000, with significant contributions from non-governmental organisations, civil society and the international community.

Thus, poverty in Serbia is primarily a consequence of the dramatic falls in GDP, the level of employment, incomes and living standards in the 1990s. Although the situation has improved in the period between 2001 and 2003, mostly owing to the successful initiation of reforms and to international support which has enabled significant growth in GDP, salaries, pensions and other personal income, it is too short a period to make up for the downturn which took place in the previous decade. One favourable circumstance is that inequality in income distribution is still moderate. On the other hand, if measures to provide support for vulnerable and socially excluded groups do not succeed in Serbia, there is a real danger that new forms of poverty will result from the implementation of necessary economic and social reforms.

## **2. How many poor are there in Serbia and who are they?**

In 2002 there were approximately 800,000 people (10.6% of the population or 250,000 households)<sup>1</sup> below the national poverty line, with a consumption (by consumer unit)<sup>2</sup> of less than 4,489 Dinars or 72 USD per month, i.e. 2.4 USD per day<sup>3</sup>.

The poverty line was defined in two steps. The first parameter defined was the absolute poverty line, on the basis of a minimum consumer food basket and minimum daily calorie intake— 2,288 (in accordance with the nutrition recommendations of the FAO). The minimum consumer food basket for a four-member household<sup>4</sup> cost 7,605 Dinars a month. The second was the complete poverty line that, besides food expenses, also includes expenses for clothes and shoes, hygiene and household goods, transport, healthcare and education, etc. It was defined as the total consumption of the households whose food consumption equals the minimum consumer basket. In that way the poverty line for a four-member household was defined and it is 4,489 Dinars by consumer unit.

This basic empirical finding should be taken only as initial information for the formulation of a complete poverty reduction strategy, since a shift in the poverty line from 4,489 Dinars to 5,507 Dinars (that is from 2.4 USD to 2.9 USD per day) would

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<sup>1</sup> All findings are based on the most extensive Survey on the Living Standard of the Population to date (May – June 2002) on Serbian territory (excluding Kosovo and Metohija) which included 6,386 households, or 19,725 individuals.

<sup>2</sup> Consumer unit allows for the differences in the consumption of adults and children as well as for the joint costs of the households.

<sup>3</sup> Using the official exchange rate of the Dinar to the dollar.

<sup>4</sup> Four-member household includes two adults, one child of up to seven years of age and one child between 7 and 18 years of age.

increase the number defined as poor in Serbia to 1,600,000 (474,000 households), i.e. to 20%. It should also be noted that this analysis did not fully include refugees and internally displaced persons, nor Roma who are the most vulnerable (the risk of poverty for them is much higher than for the rest of the population)<sup>5</sup>.

Basic poverty indicators are shown in the following table:

### Poverty indicators in Serbia in 2002

	Population at risk of falling below the poverty line (poverty line = 5.507 din.)			The poor (poverty line = 4.489 din.)		
	Poverty index	Poverty gap <sup>6</sup>	Poverty severity <sup>7</sup>	Poverty index	Poverty gap	Poverty severity
<b>Urban</b>	16,0%	3,3%	1,1%	7,8%	1,5%	0,5%
<b>Rural</b>	25,1%	6,1%	2,3%	14,2%	3,2%	1,1%
<b>Total</b>	20,0%	4,6%	1,6%	10,6%	2,2%	0,8%

Source: SLSP 2002

Besides the basic indicators on the extent, depth and severity of poverty, the analysis pointed to the following characteristics of poverty in Serbia:

- **Poverty in Serbia is closely related to educational level.** The risk of poverty<sup>8</sup> for people who had not completed primary education was twice as high as for the general population. The depth and severity of poverty was significantly greater for this group than for those with more education. By way of comparison, only 2% of university graduates were poor.
- **The unemployed** (those participating in the formal labour market) were most at risk of poverty (59.4% higher than the population average) as well as being likely to experience the greatest depth and severity of poverty. The most vulnerable were the unemployed in rural areas, whereas the employed in urban areas were in the most favourable situation.

<sup>5</sup> If subjective criteria of poverty were applied, based on the individual's opinion on the level of income needed to satisfy basic needs, more than a half of Serbia's population would be classified as poor.

<sup>6</sup> The depth (gap) of poverty indicates the amount of resources (as a percentage of the poverty line) needed to bring the whole population above the defined poverty line (under the ideal condition of perfect targeting of financial transfers).

<sup>7</sup> Severity of poverty is an indicator which shows how far below the poverty line certain categories are.

<sup>8</sup> The risk of poverty is calculated as a percentage increase (fall) in the poverty index of an observed group compared to the average poverty index of the whole population.

- **The elderly (over 65)** make up almost a quarter of the total number of poor, 17.7% of the total population, with the most at risk being the elderly without pensions.
- **Children** also represent a category with an above average risk of poverty. 12.7% of this age group were poor, and their relative risk of poverty was 20% higher than the population average. Their poverty was relatively deep compared to other age groups.
- On the basis of household size, the most vulnerable were **households with five or more members** (poverty risk +26.3%). According to household composition, poverty is most prevalent in **single-person and especially two-member elderly households** where the risk of poverty is almost two thirds higher than the population average. Their depth and severity of poverty was much higher than the average, especially in rural areas.
- **Poverty in Serbia has become a rural phenomenon** (as in the majority of transition countries) primarily because of faster real growth of wages and pensions, which are the predominant source of income for the urban population. The poverty index of the rural population (14.2%) was almost twice as high as the poverty index of the urban population. Compared to the urban population, people in rural areas are confronted with higher risk, depth and severity of poverty.
- **The region with the highest level of poverty is Southeastern Serbia, especially rural areas** which are two times more exposed to a risk of poverty than the average population. Poverty in this region is deepest and most severe. 25% of the poor are from the rural population of the south-east and part of western Serbia.

***Poverty of particularly vulnerable and economically and socially excluded groups***

Policies and strategies for overcoming poverty among refugees and internally displaced persons, Roma, persons with disabilities, and for dealing with gender aspects of poverty have been included as a central part of the PRSP. In addition, these issues are considered in detail in the special Annex of the PRSP.

The most important poverty indicators pertaining to these groups are:

- According to economic and social position, **refugees and internally displaced persons belong to particularly vulnerable groups in Serbia**. People in collective centres (18,500) are in the most difficult position. Although the number of refugees has been decreasing (primarily through return to Bosnia and Herzegovina or through full integration in Serbia), it is still large, 278,000 according to the latest data. Due to the absence of security and other conditions for return to Kosovo and Metohija, the total number of internally displaced persons is still around 230,000. According to assessments and available data it is estimated that over 120,000 or around 25% of refugees and internally displaced persons belong to the category of the poor, which is twice the level in the local population. The situation is similar when it comes to employment and housing conditions.

- **Compared to other vulnerable groups, Roma are the poorest and most vulnerable.** According to the 2002 census there are 108,000 Roma in Serbia, but domestic and international estimates indicate that their actual number exceeds 300,000 (since in the census a certain number of Roma declared themselves as members of the majority nationality)<sup>9</sup>. Among Roma there is the highest risk of a continuing cycle of poverty and this is reflected in all crucial areas: employment, education, health care, and housing. According to estimates the unemployment rate among Roma is four times higher than in other groups. The 2002 census shows that 32.5% of Roma are without any education or have completed less than 4 grades of primary school. The life expectancy of Roma is estimated as considerably shorter than that of the overall population, which indicates that their living conditions present considerable health risks.
- **Persons with disabilities are also a particularly vulnerable group** (according to estimates the total number of persons with disabilities is about 350,000). According to 2001 NGO research, there is a large share of the poor within this group. The reasons for this partly lie in low educational levels and limited employment opportunities. Only 13% of persons with disabilities have the opportunity to work, and only one third have a job adjusted to their needs.
- The Survey on the Living Standard of the Population indicates an equal poverty rate for men and women. However, **a series of other indicators demonstrates the unfavourable economic and general position of women in Serbia:** a higher share of women without regular personal income; due to poorer qualifications and shorter service spans, women on average have 15% lower wages than men; they wait longer for jobs and it is more difficult for them to find one; there is a greater probability that women will be exposed to poverty in old age due to lower incomes; following divorce women predominantly or totally support the children, and they may also need to support children born outside marriage. Those most at risk from poverty are elderly women in rural areas, single mothers, housewives, Roma women, refugees, the uneducated and unemployed, the sick and women with disabilities, and victims of violence.

### 3. Main Strategic Directions and Challenges in the Implementation of the Poverty Reduction Strategy

Strategies for dealing with poverty in Serbia need to respond to its main causes, characteristics, and profile. On the one hand the Poverty Reduction Strategy must focus on economic development, because the main cause of poverty is the low level of GDP per capita (about 2000 USD in 2002) and the low proportion of the population who are employed and active in relation to those who are dependent on support. On the other hand

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<sup>9</sup> Certain Roma associations estimate the number of Roma to be much higher

the PRSP defines poverty as a multidimensional phenomenon that in addition to reflecting insufficient income for satisfying basic needs also includes the lack of employment opportunities, and inadequate housing conditions and access to social protection, health, education and utility services, particularly in the case of vulnerable and socially excluded groups, as well as an inability to exercise basic human rights and the right to a healthy environment. Such an approach directly links the PRSP with the realization of the key UN Millennium Development Goals and EU recommendations for the process of European integration.

The PRSP represents a holistic plan of activities aimed at reducing key types of poverty by creating financial and other preconditions and by offering everyone the opportunity to support themselves and their families. Serbia has sufficient human, financial and natural resources to eliminate – in a relatively short period of time and relying on its own strengths with the assistance of the international community – the most acute forms of poverty, which are particularly prevalent in underdeveloped regions and concentrated among the most vulnerable groups.

#### **The three main directions of the PRSP are:**

**In the first place**, a strategy of dynamic economic growth and development, with an emphasis on job creation. This implies the continuation of the policy of macro-economic stabilisation; the creation of an environment attractive to foreign investment and the mobilization of domestic investments; accelerated restructuring and privatisation which will revitalize those state/socially-owned enterprises capable of becoming market-oriented and competitive; development of a financial market; legal protection of property and contracts; creation of a business environment conducive to the development of entrepreneurship and faster development of small and medium enterprises; development of the control functions of the state which would legalize the so-called grey economy; strong efforts to combat corruption and organized crime; and efficient functioning of state institutions – legal, executive and judicial authorities. The increase in economic activities and the greater international competitiveness of the domestic economy will lead to an increase in GDP, creation of new jobs, higher incomes and real sources for financing social and other public needs. This is a key development direction and the priority for Serbia, and is the only way to improve the lives of the citizens and at the same time eradicate poverty permanently.

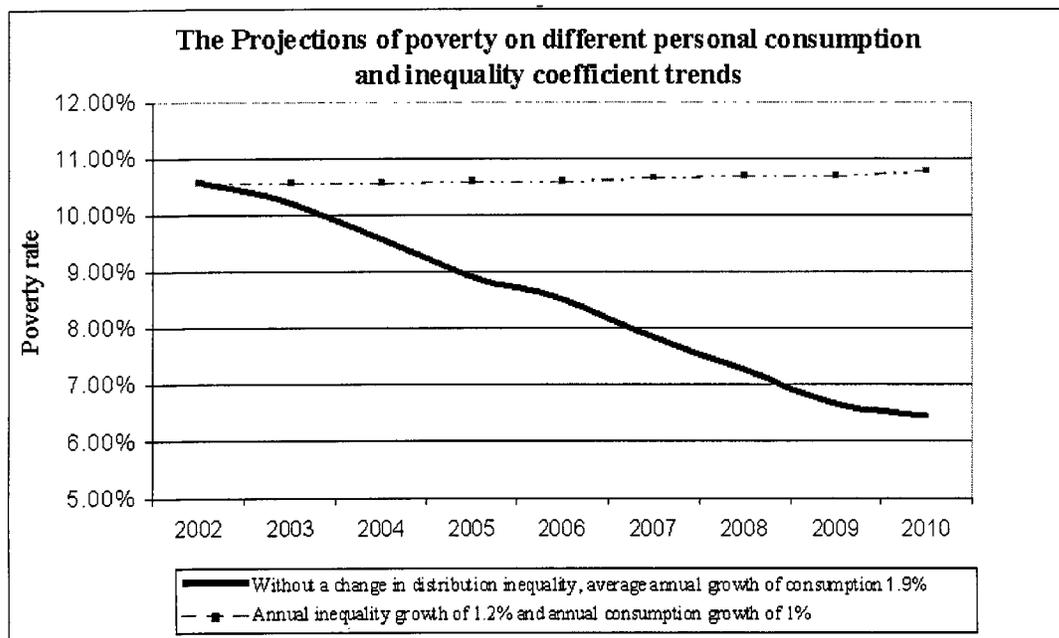
**The second strategic direction** is the prevention of new poverty that will result from the modernization and restructuring of the economy. A large number of people should be trained to work in the newly privatised economy on new jobs in the production and service sectors. Significant economic and social efforts will be required, particularly in regions with a traditional economic structure and with no market prospects. The availability of considerable financial resources represents a necessary, but not a sufficient condition. The state with its institutions in close cooperation with municipal authorities and local communities, through its own activities and the mobilization of non-governmental organizations, and with the anticipated assistance of the international

community, should offer economically and socially acceptable alternative work for the considerable number of employees who will become redundant as a result of the process of transition.

**The third strategic direction** involves the efficient implementation of existing programmes, as well as the development of new programmes, measures and activities directly targeting the poorest and the most vulnerable groups (children, the elderly, disabled people, refugees and internally displaced persons, Roma, the rural population and uneducated persons), particularly in the least developed regions. In relation to the most visible forms of poverty, this will enable not only the survival of these groups, but also their equal access to employment, health services, education and utilities. A permanent improvement in the economic and social status of the most vulnerable groups will, more importantly, prevent a continuing cycle of poverty within these groups.

**Successful implementation of the PRSP requires:**

- Determined continuation of market reforms which have been initiated and the building of modern and efficacious state institutions, based on the rule of law and the fight against corruption, as well as the inclusion of Serbia in the process of European integration.
- Dynamic and sustainable economic growth in the years ahead with the maintenance of macroeconomic (internal and external) stability and the current pattern of income distribution.
- Establishing priorities for solving the basic problems of poverty, related to faster employment growth, more efficient social protection, and better access to health and educational services and housing opportunities, taking account of the urgent needs of the most vulnerable groups and underdeveloped areas.
- Defining PRSP costs in the context of the available fiscal resources projected by the public expenditure plan for Serbia (2004-2006) and the level of support from the international community and donors.
- Creating an overall system for monitoring the implementation of the main activities of the Strategy and the realization of its key objectives with the active participation of all relevant stakeholders, in order for there to be effective national ownership of the PRSP and for it to be an efficient tool for poverty reduction in Serbia.



A successful response to these challenges will mean a reduction of poverty in Serbia to some 6.5% in the year 2010, with an average annual GDP growth of 4-5% and an increase in personal consumption of about 1.9%. The graph above also shows the pessimistic scenario; in conditions of slow economic growth (2-3%) and an increase in inequality of income distribution, poverty in Serbia will remain at the same level and there will be very limited resources available for helping the most vulnerable.

#### 4. Transition and Reform Framework for Poverty Reduction

After the democratic changes in October 2000 monetary and fiscal reforms were implemented, leading to macro-economic stability and the reduction of inflation to 9% in 2003. However, it is proving more difficult to implement comprehensive institutional reform and it faces greater resistance, both from those facing the loss of existing positions and privileges, and those who will suffer hardship in the first stage of transition such as the many workers in large socially or state-owned companies who will be made redundant.

According to all estimates, **privatisation** in Serbia has been carried out successfully and swiftly. From 2002 through to September 2003, 25 large companies had been privatised through tendering; the sectors they come from include cement production, chemicals, tobacco, iron and steel and pharmaceuticals. The purchasers were well-known international companies: Philip Morris, Lafarge, Holcin, Titan, British American Tobacco and Henkel. 692 small and medium-sized companies were privatised through auctions. The total sale value amounts to one billion and 83 million Euros; planned investments are 567 million Euros and social programmes (for redundancies) will amount to 253 million Euros. The restructuring and privatisation of large socially and state-owned companies and public companies is planned for the next phase. The new law on

bankruptcy (to be adopted in 2003) will enable the liquidation of enterprises which cannot be privatised because they are not economically viable and have an accumulation of debts. It is intended to use the proceeds from privatisation to generate employment and accelerate economic growth, through capital investments in infrastructure and agriculture (irrigation) etc.

It is anticipated that the share of the private sector in the economy will increase from 42.5% in 2002 to 75% in 2005.

**Development and reform of infrastructure activities** requires completely new legislation, a new regulatory regime, and institutions to implement this regime. Reforms in these areas should take place in 2004.

The Poverty Reduction Strategy sets out two strategic directions in this field.

The first is a major increase in investment in infrastructure, both at the national level (motorways, electro-industry, telecommunications) and at the local level (water supply, local roads etc.). A significant proportion of soft loans and donor funds have already been earmarked for the modernisation of infrastructure in Serbia. In addition to having general positive effects through attracting foreign investors, generating economic growth and contributing to poverty reduction, the creation of jobs associated with it (especially in construction) will contribute directly to improving the economic position of the low-skilled labour force.

The second is pricing policy relating to electricity, gas and water supply. In the case of the supply of electricity, which is a major problem for the poor, it is proposed to reform the tariff system to reflect actual costs, and to improve the position of the most vulnerable households through direct subsidies. At the same time, financial support to encourage switching to cheaper alternative fuels is also envisaged.

**Tax reform and public debt servicing has had a favourable direct impact on living standards and poverty reduction.**

Changes in consumption taxes (in particular sales tax) and taxes on salaries during 2001 have had a direct impact on living standards and poverty.

The initial list of products exempt from sales tax was subsequently expanded so that at the beginning of 2003 it included basic food products, utilities, basic medicines, etc.

A decrease in taxes and contributions on salaries by ten percent has led directly to an increase in average salaries of approximately 10%, and consequently an increase in pensions and social transfers.

The commencement of state debt servicing toward the population (old foreign currency savings, large debts towards pensioners) contributes to the alleviation of poverty, since a considerable part of these debts is paid to the elderly population (in 2003 the total payments for this purpose will be approximately 1.7% of GDP).

The **formulation of a radical tax reform** which should introduce significant changes into public finances in Serbia is in progress. The basic element of the reform is the introduction of Value Added Tax which will replace the sales tax as of 1<sup>st</sup> January 2004. In addition, this tax reform is expected to abolish a large number of taxes that are unfavourable in terms of allocation, lack transparency, and impose high administrative requirements, while at the same time fail to generate significant fiscal yields, such as taxes on financial transactions. Direct taxes, such as income tax, will be simplified and made easier to collect. New policies relating to property tax will increase fiscal revenues from taxes on real estate, whereby taxes on property such as securities will be abolished. Finally, it is expected that a large number of duties (as typical fiscal mechanisms inherited from socialism) will be abolished and replaced with appropriate taxes. These changes and other elements of tax reform will allow the creation of a modern tax system in Serbia, which will stimulate economic growth and thus create conditions favourable to the reduction of poverty.

### **Budgetary processes, public expenditure management and public procurement**

During 2002 a Law on the Budget System and a Law on Public Procurement were adopted.

The Law on the Budget System introduces a more rigorous professional and political (parliamentary) verification of demands made by budget users, as well as better linkages between spending plans and agreed social and macroeconomic goals. During budget implementation and planning for social insurance funds, the application of clearly defined procedures decreases the possibility of abuse and waste of resources.

The application of the Law on Public Procurement introduces competition into the purchase of goods and services, which, within the given expenditures, secures better supply and quality of services. The application of this law is especially important from the point of view of social protection because it secures better quality services in health and education within the given level of expenditure.

Significant progress in the management of public finances has been achieved by the introduction of long-term planning for the most important fiscal aggregates.

As a part of the regular annual budget procedure as of 2002 a Memorandum on Budget, Economic and Fiscal Policy has been prepared. The Memorandum sets out three-year projections of public revenues and expenditures, and the fiscal deficit, and proposes sources to cover the deficit and public debt. Apart from aggregate positions these projections also show planned changes in the tax system and in the structure of public expenditures. In addition, the Ministry of Finance and Economy has made internal projections of sustainable fiscal policy up to 2010. The policy also includes planned changes to the structure of public expenditure. These projections represent the analytical background for maximising the efficiency of public spending in Serbia.

**The reform of the banking system** has been continuing quite successfully. The four largest insolvent banks were liquidated, several domestic banks received injections of foreign capital, and several foreign banks started operating. This increased competitiveness in the market and reduced the price of capital. However, as far as SME development is concerned, conditions for obtaining loans for small and new entrepreneurs are still unfavourable. The situation has significantly improved with the recent adoption of the Law on Mortgage on Movable Property Entered in the Register (which reduces the risk attached to future due payments), and the previously adopted Laws on: guarantee fund, financial leasing and concessions and expected regulations in regard to their provision of crediting.

### **Continuation of institutional reforms**

The main task and challenge facing the Government and all other reform-oriented forces in Serbia lies in the implementation of thorough institutional reforms, primarily judiciary reform, together with the establishment of the rule of law and a determined fight against corruption. In parallel with this, the continuation of market reforms is necessary: the privatization and restructuring of the property and financial sectors and the creation of infrastructure and other incentives for the development of a market economy, to promote economic efficiency in resource utilization and encourage new private investments<sup>10</sup>.

**Judicial reform** must be accelerated to bring about the full establishment of the rule of law, protection of property and contract, and above all the protection of the rights of investors and creditors. It is very important that the fight against organised crime, which became a priority after the assassination of the Prime Minister, leads to a comprehensive reform of the judiciary, especially of those areas which are critical for regular and unhindered performance of business operations.

In early 2002 five laws relating to the judiciary were adopted; they are in accordance with European standards which protect basic rights and freedoms of citizens, secure full independence of the judiciary, and its separation from legislative and executive authorities. These are the Law on Courts, on Judges, on Judiciary High Council, on Public Prosecution, on Headquarters and Areas of Courts and Public Prosecutors. It is very important to restore public trust in the judiciary. This, among other things, implies affordable and simple access to the legal system, the reduction and final eradication of corruption, controlling the level of court tax (development of a free-of-charge legal help system), the exemption of socially vulnerable categories from the payment of court taxes (the institute of rights for the poor) and the adoption of the Law on Ombudsman.

A well organized and competent **public administration** is a key precondition for successful integration into the EU. The major feature of public administration reform in

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<sup>10</sup> See Annex for all reform laws adopted after October 2000, together with laws currently in parliamentary procedure and those that are being prepared.

Serbia is a transformation from authoritarian administrative decision-making to administration as a public service equally accessible to all. For this purpose laws on public administration and public servants, on general administrative procedures, on administrative disputes and on administrative courts are being drafted. These laws will abolish (or dramatically reduce) the discretionary rights of administrative bodies to grant or deny citizens the exercise of their rights. The immense task that lies ahead is to improve the qualifications of public administration employees at all levels and help them adjust to the requirements of reform. The PRS also envisages pilot participatory projects aimed at involving vulnerable groups in the modernisation of the administration of certain municipalities. The objective of the PRSP is to support the creation of a dynamic, efficient and transparent public administration in line with the new role of Government in the market economy, as well as with private sector development and stable legislation.

**Decentralisation of local government.** The new Law on Local Government (2002) only initiated decentralisation while the forthcoming constitutional reform (the new Constitution) will create the legislative basis for full decentralisation and the functional reform of all levels of government. Municipal authorities should acquire significant competences in the provision of improved living conditions and the promotion of poverty reduction. It is easiest to identify problems of poverty at the community level, where concrete programmes for poverty reduction can be developed based on proposals by members of the public, local organizations, and NGOs (the adoption of the Law on NGOs is also necessary in this respect). Local authorities can establish a more direct relationship with citizens and hence more easily stimulate partnership between the private and the public sector and create an environment which is attractive for investment and the launching of development and poverty reduction projects.

For this reason the PRSP envisages the strengthening of the role of socio-economic councils in municipalities and the establishment of mechanisms to stimulate comprehensive measures to protect the poor at the local level. The strategy also calls for the further strengthening of mechanisms such as the Social Innovation Fund, stimulating decentralization in the field of social protection. Partnership between government, local authorities and all relevant stakeholders will enable implementation of the PRSP at the local level.

### **Poverty Reduction Strategy Local Initiatives (PRSPLI)**

The objective of the PRSPLI pilot projects was to strengthen national ownership of the Strategy. This was accomplished by a series of “bottom-up” initiatives throughout Serbia, aimed at raising local community participation in the preparation and implementation of the PRSP. This mechanism will be continued during the implementation and monitoring of the PRSP.

**The fight against corruption.** Corruption adversely affects attempts to reduce poverty both directly and indirectly. The direct effect is that the poor are denied access to numerous public services (in public administration, health care and education) because

additional payment is often required. The indirect effect is that the extent of corruption greatly discourages foreign investors which in turn threatens economic growth and thus the scope for poverty reduction.

In the 1990s corruption was widespread in Serbia as a direct consequence of the authoritarian regime, extensive state intervention, and economic sanctions which blocked the development of a market economy and of a democratic society.

The new democratic Serbian Government placed the fight against corruption among its priorities and formed an Anti-corruption Council; the adoption of a set of anti-corruption laws is expected by the end of 2003. In 2001 the non-governmental sector made a significant contribution to the fight against corruption by proposing a comprehensive plan of actions. The Government of Serbia has already accepted some of the proposed policies such as the Law on Public Procurement; an Anti-monopoly Law is being drafted and some positive steps have been taken towards transparency in the work of state bodies, and the reform of the judiciary and police.

## **5. The International Integration of Serbia**

The fact that Serbia has joined international economic and financial organisations and made some initial steps towards EU and WTO accession has created the basis for Serbia's further integration into Europe and the wider world, with the aim of enabling faster economic and overall development.

In August 2003 an Action Plan for the harmonisation of economic systems in Serbia and Montenegro was adopted. The plan aims at the creation of a common market and the removal of obstacles to the free flow of people, commodities, services and capital. How soon the common market in Serbia and Montenegro will start operating depends most directly on membership of the World Trade Organisation and the signing of the Stabilisation and Association Agreement.

Membership of the WTO will have a number of effects on poverty reduction, including: an increase in national income through faster economic growth, reductions in the prices of some products, further foreign trade liberalization, and the according of privileged status to Serbia and Montenegro as a transition country.

Through the Stabilization and Association Process (SAP) the EU has encouraged Serbia to prepare for full EU membership by working to achieve very high standards relating to the economy, the functioning of the rule of law, democratization, and human rights. The Feasibility Study that is currently being prepared will show how ready Serbia and Montenegro are to sign the Stabilization and Association Agreement which is the key point of the SAP.

Serbia has prepared an Action Plan for bringing the laws of the Republic of Serbia into line with EU regulations and has drawn up a Plan of Activities for the implementation of EU recommendations relating to the European integration process.

Serbia's entry into European Integration and the PRSP are closely linked in the following ways:

- Through the assistance of EU CARDS, involving programmes and significant resources on each key sphere of the stabilization and association process.
- The EU has allowed Serbia asymmetrical trade preferentials which stimulate production and consequently employment.
- The Stability Pact for South Eastern Europe plays an important role in addressing problems of refugees as a particularly vulnerable group.
- The EU has allowed participation in so-called "twinning" programmes which help the creation of a European economic environment in Serbia.
- The European Strategy for the Reduction of Poverty and Social Exclusion (Lisbon, 2000) is compatible with the measures and activities envisaged by the PRSP.

## **6. Macroeconomic Framework and Factors of Sustainable Economic Growth**

Dynamic, sustainable economic growth is the key precondition for a successful PRSP. Policies which boost economic growth and employment without increasing inequality in income distribution are the main levers for poverty reduction.

When projecting economic growth rates for the years ahead it is necessary to be both ambitious and realistic. The low level of GDP per capita of about US\$ 2 000 in 2002 calls for higher growth rates. On the other hand, there are constraints and risks related to the sustainability of such growth in the long term.

In 2001 and 2002 Serbia had an economic growth rate of 5.5% and 4% respectively, while the rate for 2003 was projected at about 3%. At the same time, considerable macroeconomic stability has been achieved. Inflation dropped from 39% in 2001 (assessed at the annual level) to 14.8% in 2002 and to an expected 9% in 2003<sup>11</sup>. With price liberalization (eliminating the main price disparities), the foreign currency exchange rate was set at the market level; a flexible exchange rate regime was introduced followed by convertibility in current transactions (Article VIII, MMF). On average, monthly earnings rose considerably (from USD 98 in 2001 to USD 175 in 2003) while inequality in distribution has not risen significantly (the change in the Gini coefficient has been from 0.3 to 0.35).

As for growth factors – human, material and natural –the main limitations concerning low levels of domestic savings (only 2% of GDP in 2002) and to date an insufficient inflow of foreign direct investment need to be understood. These are key generators of growth and

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<sup>11</sup>By way of comparison, in 1993 Serbia and Montenegro experienced an unprecedented hyperinflation expressed in billions of percent.

new employment as well as necessary for maintaining the current balance of payments deficit below 10% of GDP.

The PRSP counts on an ambitious, but according to projections an achievable, average annual growth in GDP of about 4-5% until 2010. At such a rate Serbia would not achieve a per capita GDP of over USD 3 000<sup>12</sup> until 2007 (for comparison, Serbia had a GDP per capita of over US\$ 3 000 as long ago as 1990).

The main conditions for the attainment of this goal in the period 2004-2010 are:

- A significant change in the structure of GDP: domestic savings must rise from the current level of 2% to 19% of GDP, the share of investment (both domestic and foreign) must rise from the current level of 14% of GDP to 25% with a simultaneous drop in personal spending from 91% of GDP to 71% as well as the reduction of public spending from 18.6% to 15%.
- That an internal macroeconomic balance is achieved through gradual and moderate reductions of the share of public spending in GDP from 46% in 2002 to 43.1% in 2010. The total fiscal deficit would drop from the current 3.5 % of GDP to 1.9% in 2010, financed in the first phase primarily from the proceeds of privatization.
- That the sustainability of the external economic balance is possible with the decrease of the current balance of payments deficit from 12% of GDP to 8.8% in 2006 and 6% in 2010 (which is in the acceptable range according to international criteria). The main source for financing the deficit should be foreign direct investment from about 5% to 7% of GDP or 1.3 to 1.6 billion dollars a year. Such a large inflow is necessary to decrease indebtedness for the financing of the current deficit from 4% to 1% of GDP. In this way the foreign debt:GDP ratio will fall from 66% to an acceptable level of 51%.

The conditions outlined above will be difficult to achieve and entail various risks, but they are nevertheless considered to be achievable for the following reasons:

- There is a favourable circumstance that in the first years of the medium-term period it is possible to achieve economic growth with less investment per unit of production (since some of the capacities of the preceding period are still usable).
- From early 2001 there has been considerable success in the creation of a favourable environment for the growth of savings and investments. Public savings

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<sup>12</sup> The latest projections of the IMF (July 2003) project a somewhat slower growth: 4% for 2004 and 4.5% for 2005). These projections are basically sustainable for all rates between 4% and 5%. Maintenance of the external economic and fiscal balance is also mutually consistent in the two analyses.

in banks grew from EUR 20 million in 2001 to over EUR 1 billion in 2003. The remaining public savings of about EUR 3 billion which are at present outside the banking system will gradually be activated with the revival of public trust in the banking system as it becomes sound and competitive, and the development of new financial institutions (voluntary pension funds and similar bodies).

- In the real sector the first effects of the restructuring of the economy are evident – a rise in profits in some enterprises and a fall in losses in others – which increases potential savings. Privatization and better financial discipline (adoption of the Law on Bankruptcy) will further reduce losses and increase profits. It is estimated that overall investment into fixed funds have risen from about 12% of GDP in 2001 to nearly 16% of GDP in 2003.
- By the creation of the Guarantee Fund, the state partially provides banking credits to small and medium enterprises which makes for a considerable inflow of savings into this dynamic sector, supported by the activities of the Republican government as well as the regional agencies for SMEs.
- As a result of the reduction of the systemic risks there has been a drop in real interest rates from over 20% in 2001 to about 8% in the second quarter of 2003.
- Public investment is also expected to rise from the current 2% of GDP to 4% of GDP in the medium term.

Investment in infrastructure is one of the generators of growth in economic activity and employment and a vehicle for poverty reduction.

About one third of overall investment in the period from 2004 to 2006 is expected to be in the modernization of infrastructure (transport, energy, telecommunications, utilities, and irrigation). This will be financed from the funds of public enterprises, commercial credits, budgetary resources (central and local budgets) as well as from anticipated donor funding and soft loans.

From budgetary resources, in the period 2004 - 2006, about 2% of GDP is due to be spent on transport, energy and utility infrastructure and housing, while 1% of GDP is due to be invested in health, education, public administration and public order and security. Between 2004 and 2006 nearly 4 billion dollars in total will be invested in infrastructure, of which more than 3 billion would come from domestic funds, foreign investment and commercial credits while up to 800 million dollars would come from donor funding and soft loans.

Foreign direct investment is crucial for sustainable medium-term growth. The projected level of foreign direct investment ranges from 1.3 to 1.6 billion dollars a year, i.e. 5 to 7% of GDP. It is a large amount but it can be achieved through effective continuation of privatization and the creation of a favourable overall climate for investment in existing as well as new enterprises. Actual and agreed foreign direct investments of about a billion dollars just in 2003 demonstrates that the projection is realistic. A considerable

proportion of these funds is earmarked for development projects. The commencement of work on the Feasibility Study for the accession of Serbia and Montenegro to the EU together with the obligation to bring all legal regulations into line with European standards, the readiness of the state to join the Partnership for Peace, the declaration of a determined struggle against corruption and the fulfilment of all preconditions for functioning as a state governed by the rule of law offer a realistic possibility for the projected growth of foreign direct investment to continue in the years ahead.

Increasing imports from the current 19% of GDP to 35% in 2010 should be the main strategic direction of Serbia's economic development. The institutional framework for a strong expansion of imports is linked to the process of stabilization and the association of Serbia and Montenegro with the EU. The opening of the EU market to the Serbian economy, together with a phased liberalization of imports, should improve the competitiveness of the domestic economy. A similar boost to exports and foreign trade will be given by joining the WTO. Finally, foreign trade agreements with neighbouring states and initiatives for strengthening economic cooperation in the Balkans will give a further boost to the export orientation of the Serbian economy and thus to economic growth.

## **7. Strategic Directions for Reducing Poverty in Serbia**

The PRS supports a multidisciplinary approach to the problem of poverty. Thus, an orientation towards dynamic economic growth is a necessary but not a sufficient precondition for addressing the issue of poverty in its entirety; precedence needs to be given to the most important areas and the participation of socially vulnerable groups needs to be encouraged. For these reasons the implementation of the PRSP is linked to the attainment of the key UN Millennium Development Goals. It aims to abolish the worst forms of poverty by creating employment opportunities, improving health care, education, housing, and environmental protection, promoting gender equality, tackling regional, rural and urban aspects of poverty, and by working towards the realization of basic human rights.

In the attainment of these goals, the PRSP as a process is based on the reforms initiated in all key areas and on setting out measures and activities with special relevance for the reduction of poverty.

### **7.1 Creation of New Employment Opportunities**

- 1. In Serbia, the unemployed face the greatest risk of experiencing deep and severe poverty.** The official unemployment rate in Serbia is nearly 30%, that is, one million people. However, the actual situation is slightly better. A large number of those officially unemployed have been registered with the Labour Market Bureau in order to qualify for health care insurance and financial compensation while at the same time they work in the grey economy. According to the SLSP, in 2002 around a million people worked in the grey economy.

Features of unemployment which give rise to concern include the following:

- The prevalence of long-term unemployment - more than a third of the unemployed have been seeking work for over a year.
  - The predominance of the youngest age group (15 to 25) in overall unemployment (40.7%).
  - The higher level of unemployment for women than for men although women tend to have a higher level of education overall.
  - The level of unemployment among refugees and internally displaced persons, Roma, and persons with disabilities, which is twice as high as that of the rest of the population.
- 2. Alleviation of poverty as a basic strategic objective** requires a wide range of mutually consistent policies, measures and activities aimed at reducing the current level of unemployment and preventing the newly created surplus of labour from becoming permanently unemployed.

### **2.1. New employment opportunities**

Increased internal and foreign demand in the field of production and consumption represents the main lever for faster economic growth and employment. Increased internal demand will result from a combination of the following factors: an increase in foreign direct investment through privatisation, increased greenfield investments, a rise in purchasing power and domestic savings, and increased public investments. Increased external demand will mainly be driven by the following factors: liberalization of foreign trade, increase in exports, strategic localization, free trade agreements, participation in the WTO, and European Integration.

In the preceding section projections and basic presuppositions for achieving a yearly GDP growth rate of 4-5% in the coming period, which together with rise in work productivity, creates opportunities for faster job creation, were discussed.

In early 2003 the Government of Serbia adopted the Strategy for SME Development which projected a rise in the number of small and medium-sized enterprises from 270 000 to about 400 000 by 2008. This would create new jobs, first of all in the processing of farm products, and in light manufacturing and service industries. The Guarantee Fund of the Republic of Serbia and crediting by the Republican Fund for Development will facilitate the raising of funds.

It is of the utmost importance to create a legal framework for the operation of **institutions that provide micro-credits** under more favourable conditions and through simpler procedures. This is especially important for citizens and entrepreneurs who are not very well off. However, for the development of entrepreneurship the most important preconditions are: the creation of a favourable market environment, abolition of lengthy and unnecessary procedures

for setting up new businesses, and the development of business initiatives at the local level in cooperation with non-governmental organizations and other interested parties.

In view of the fact that the agricultural sector produces some 25% of GDP, the Government of the Republic of Serbia has included among its strategic development objectives the creation of a dynamic and sustainable **private agricultural sector** (see the chapter on rural development) that would on the basis of its own comparative advantages create new employment opportunities.

## **2.2 Creation of an efficient and flexible labour market**

Important institutional changes were introduced by the Labour Law (2001) and the Law on Employment and Unemployment Insurance (2003) which established relationships between employers and employees consistent with a market economy and private property relationships. The Law on Health and Safety at Work should be implemented in 2003 as well as laws on trade unions and employers' associations, on the peaceful settlement of collective and individual labour disputes, on strikes and on the employment of persons with disabilities. The active role of socio-economic councils at the Republican and local levels is of particular importance in resolving these issues.

Incentives for new employment. This refers to economic incentives where the state contributes to the improvement of the supply of labour of existing workers and the newly employed, involving changes in the structure of labour supply and its flexibility, as well as encouraging the demand for labour. These measures will be delegated to the regional and to the local level in order to direct the programmes as much as possible to the target groups. Budgetary funds (central and local) will as far as possible be redirected towards active measures.

Improving the value of human capital. Privatization and modernization of the Serbian economy will create a new economic structure in which trade, transport, and financial and other services will become increasingly important. For this reason, permanent programmes for retraining and additional training of those who are currently unemployed are of the utmost importance, as is educational reform. Cooperation with employers also needs to be improved. With this objective in mind, the programmes of the PRSP attempt to bring the skill structure in line with the future needs of the economy and society.

### Specific measures for supporting employment

- Employing the 'surplus' workforce – in 2002 the Government adopted the Social Programme which provides for the use of budgetary funds for various socio-economic policies for dealing with this problem. So far the most frequently used has been the one-off financial compensation (USD 100 for

each year of career service, or 10 average monthly salaries). Other possibilities for employment and obtaining additional qualifications are so far much less used.

- The PRSP includes programmes for granting subsidies to employers to partially reimburse the labour costs incurred through employment of the elderly, refugees and internally displaced persons, persons with disabilities and other vulnerable groups. The programmes would be financed from the central and local budgets as well as from donor funding.
- Self-employment is encouraged by the Government by directing grant funds to social programmes and severance payments.
- Public works are aimed at employment of socially vulnerable groups on works of public interest (dealing with public utilities, and humanitarian, social and other activities). This will be financed from central and local budgets.

The success of the employment policy facilitated by the new Labour Law depends on the establishment of a “broad partnership” of key stakeholders: the Government, employers, trade unions, the unemployed, local selfgovernment and intermediary services. In this process, social dialogue and the affirmation of tripartism represent particularly important elements.

Integration of the grey economy into legal channels will be gradual, taking into account the fact that a considerable proportion of the population, especially the poor, work in the informal sector. The PRSP supports the creation of conditions that will discourage workers and employers from taking part in the informal sector. It is therefore important that labour regulations should be further liberalised, the fiscal burden further reduced and the control of the collection of public revenues improved. In short, these measures will create circumstances in which it does not pay to work in the grey economy.

## **7.2 More Efficient Social Protection**

- 1. Two basic social protection programmes for the alleviation of poverty in Serbia are:** Material Support to Families (MOP), at present received by 125 000 beneficiaries; and children’s allowances, received by about half a million people.

Material Support to Families (MOP) is modest –about USD 20 per beneficiary. However, this is the best-targeted social transfer in Serbia (52% of the money goes to the 10% of the poorest citizens), primarily received by the unemployed and those unfit for work, and their children.

At the end of 2002 one child in every three in Serbia was receiving children’s allowance to the amount of USD 18. Children from single parent families and children with special needs receive 30% more.

An important part of social protection is directed at children without parental care, elderly persons who are unable to take care of themselves and persons with

disabilities. Most social security services are provided by the Social Welfare Centres that can be found in almost all municipalities.

In 2001 and 2002 special budgetary interventions and considerable donor funds helped to cover large arrears and to establish regular payment of social assistance. Conditions in the social welfare institutions were improved through the use of the same funds. (As a result of donor funding, in 2001 alone more was invested in equipment than in the whole of the preceding decade).

Another problem is that a considerable number of the poor do not take advantage of the social programmes they are entitled to, owing to a lack of information, the lack of a permanent address (as is often the case with the Roma), lack of skills necessary for dealing with red tape, geographical inaccessibility (with respect to institutionalised forms of social protection services). An additional problem is presented by poor refugees who do not have the right to basic financial transfers until they are granted citizenship.

**2. The main objective of the PRSP concerning social protection is the alleviation of poverty in the population as a whole and especially in vulnerable groups such as children, the elderly and infirm, the Roma, persons with disabilities, poverty-stricken refugees and internally displaced persons.**

The existing social protection system aimed at the alleviation of poverty is basically sound and modern. Further improvement in the social protection of the poorest will be ensured by the forthcoming amendments to the Law on Social Protection and Social Security of Citizens. The amendments proposed will lead to an increase in the carer's allowance and assistance for severe disabilities, the introduction of a unified income census covering 90% of the territory of Serbia and indexation of allowances to the cost of living. As for children's allowance, the coverage should still be broader than for social assistance benefits. The PRSP also proposes the introduction of a unified family allowance integrating social assistance and children's allowance, meaning more money for the poorest. This proposal needs additional research and confirmation.

The reform of the social services mainly concerns Social Welfare Centres (especially for services provided in institutions) as well as alternative forms of protection. The main objectives of the reform are: deinstitutionalization and the development of alternative forms of social protection, defining the roles of various institutions and their networking (health care, education, employment, the police, the judiciary), involving various actors in the provision of services – above all those from the non-governmental sector, – as well as giving precedence to day-care centres over institutional placements. These objectives are being pursued at the local level with the aim in due course of applying experiences from pilot projects at the national level. Although broader in concept, in the first phase these projects are mainly intended for children without parental care, children in conflict with the law, child victims of abuse, and for the protection of children from families at risk.

The PRSP also includes integrated reform projects: promotion of fostering and integrated model of social protection targeting children, the Roma, the elderly, and persons with disabilities.

The Social Innovation Fund was set up in 2003. At the local level it will finance projects which are in keeping with the PRSP and which incur transitional costs. Some projects will be defined in advance while the rest will be developed by local agencies and depend on local circumstances and problems. Projects requiring only initial financing will be given precedence, while further financing can be provided from local resources. This fund would not be oriented only towards NGOs - all social protection institutions would have access to it. This would provide an incentive for the reform of the system from within.

The project also includes the revision and improvement of areas of the social protection system dealing with persons with disabilities including issues concerning financial benefits (due to increased personal and family expenditures), institutional protection, technical aids, service providers for persons with disabilities, and similar aspects.

### **7.3 Improved Position of Pensioners and the Elderly**

- 1. The majority of elderly people in Serbia receive pensions** since old age pension insurance is mandatory for almost all employed citizens. In Serbia every fifth citizen is a pensioner.

The share of the poor is somewhat higher in pensioners than in the population at large (10.9% and 10.6% respectively) while the rate of poverty among all people over 65 years of age is 14.8%. The worst situation is in Southeastern Serbia where one in five pensioners is poor as well as one in three elderly people without a pension. In this group, at the highest risk are two-member elderly households or mixed households where an elderly person is the breadwinner. State assistance to the elderly and the infirm who cannot take care of themselves includes placement in homes for the elderly (about 9 000 beneficiaries) and financing carer's allowance (about 60 000 beneficiaries).

The main obstacle to providing broader support to poverty-stricken pensioners and to the elderly in general is the lack of budgetary resources. Pensions constitute about 12% of the GDP and about 40% of pensions are covered from the budget due to the insufficient inflow of funds in the mandatory pension funds.

The reforms implemented so far included changes in the pension indexation mechanism, introduction of a single minimum pension, lifting the retirement age limit by three years in a single move, and changes in pension calculation - taking account the whole career span, thus favouring the poor. In addition, the criterion of general disability was introduced as the eligibility requirement for a disability pension.

The reforms of the pension system are long-term by nature, including the introduction of voluntary and later (possibly) mandatory capital-based pension insurance as a supplement to the existing pay-as-you go system, and are only beginning. Finally, very unfavourable demographic trends also need to be taken into account since the over-65 elderly make up 16.6% of the overall population (according to the 2002 census) with further growth expected. This will create new and heavy financial burdens for the state through larger expenditure on pensions, health care insurance and social assistance.

**2. The main objectives of the PRSP concerning the elderly are:** alleviating poverty among pensioners and other elderly persons (both in absolute numbers and in proportion to the overall number of this population) as well as strengthening the institutional protection services for the elderly who are particularly vulnerable.

**3. The strategic policies in this area concern:**

- **The pension system reform** to include both state and private insurance, mandatory and voluntary, the pay-as-you-go system and a capital funded system. The adoption of the Law on Voluntary Private Pension Insurance is expected in 2004. The introduction of the minimum pension (now set at 20% of the average gross income), which is already in force, is of great importance for the alleviation of poverty. The introduction of a social pension for all elderly persons (over 65 years of age) is at present impossible due to financial limitations. The indexation of pensions (linked to inflation and salary increases) keeps pensions in line with general economic growth.
- For the medium-term period the PRSP supports **lifting the retirement age limit** to 65 years, which would have general positive effects both on economic activity and on regular payment of pensions.
- **Improving Social Protection of the Elderly**

The main aim of further development of support for elderly citizens is the improvement of home and community-based care. Such assistance is valuable both because the elderly prefer it to other types of support and because it is cheaper than institutional care:

- Day centers, which care for the elderly while members of their families are at work;
- Day rehabilitation centers for those who were discharged from hospitals but still need time to recuperate;
- Personal help at home including food, personal hygiene, washing clothes, cleaning and transport, and similar;
- Medical assistance at home intended for those who are sick, etc.

The PRSP supports additional activities concerning accommodation in the homes for elderly and carer's allowance as basic forms of assistance for the poor falling into this category.

The main changes concerning deinstitutionalized policies for placement of the elderly are: improving the quality of accommodation and services; improving home care; restructuring and expansion of the network of homes in broad areas of western, eastern and southern Serbia; conversion of a number of collective centres into homes for the elderly; involving the private sector in providing accommodation and care for the elderly.

As for carer's allowance, the PRSP supports the introduction of the income census into the eligibility criteria so that those who cannot pay for it themselves would get more.

Other programmes for the elderly and poor will be organised at the local level, through cooperation between municipalities, civil society and humanitarian organisations.

#### **7.4. Health Care as the Function of Poverty Reduction**

- 1. Deterioration in health in Serbia** is a result of the cumulative effects of the unfavourable events in the economic, political and social sphere to which the population was exposed in the 1990s. To this we should add aging of the population, a large number of refugees and internally displaced persons, pollution of the living and working environment, unemployment and social deprivation as well as the spread of risky life styles, especially among young people. The existing health care system cannot meet the challenges given its structural shortcomings, lack of a culture of and programmes for health promotion as well as the fact that little attention was paid to health risks in the living and working environment.

In Serbia there are not regular health statistics showing morbidity according to socio-economic status. The SLSP showed that vulnerable groups are at a higher risk of getting sick or dying from common causes including tuberculosis, AIDS, cancer, traffic accidents and violence. The SLSP also showed that among individuals below the poverty line there are 30.3% of those who have a diagnosed chronic medical condition as opposed to 26.6% in those above the poverty line.

- 2. The main objective of the PRSP in the health sector** is improvement in the overall health of the population and especially the reduction of inequalities through improving the health of vulnerable groups. The objective is to be achieved through health programmes aimed at vulnerable groups as well as through fairer redistribution of health care resources, as set out in the document "Health Policy in Serbia" (February 2002). The emphasis is placed on equal access to basic health services, which will be financed from the Republic Health Insurance Fund for those who are

insured and from the state budget for all other citizens regardless of their socio-economic status (including refugees and internally displaced persons).

### **3. Strategic Policies**

#### **Health Care Reform**

- The reform of the financing system – the basic package of health care services. It will define who, at what level and under which conditions provides certain medical services. This would finally narrow the gap between the formal, legislated entitlements of the users of medical services and the actual capacities for fulfilling these entitlements.
- Better distribution of resources (across health care levels and across regions) - preventive and primary health care will be given precedence in the future health care system. Financing by Republic Health Insurance Fund will uphold this principle through a basic set of services while the primary health care system will include the most important preventive measures such as antenatal protection, immunization as well as infant and child protection programmes, etc. Financing public health services, including prevention and suppression of diseases and early diagnosis, especially in cancers and cardiovascular diseases, is an important component of the health care system,.
- The role of local authorities in the provision of primary health care was addressed by the new Law on Local Self-Government and the draft Law on Health Care. The new Law on Concessions allows private medical practice to be integrated into the public system where the state and the local authorities would set standards and inspect the quality of services provided.
- Necessary changes in the institutional and legislative sphere – it is expected that the following laws and relevant sub-acts will be adopted by the end of 2003 and 2004: the Law on Health Care, the Law on Medications, the Law on Medical Workers Chambers and the Law on Health Insurance.

#### **Improved Accessibility of Medical Services to the Poor**

- The introduction of the health information system for monitoring the impact of transition on the poor and especially on vulnerable groups. Simultaneously there will be programmes adopted aimed at improving the accessibility of information and health care services to these groups.
- The PRSP focuses particularly on the development of national programmes for the poor and vulnerable groups. The following activities are considered to be of utmost importance:
  - Identification of specific medical and social needs of these groups the need for co-ordinated action at all levels of the community. For example, special programmes are envisaged for dealing with health protection of Roma women, women refugees and women in rural areas.

- Linking institutions of primary health care (medical centres) with social protection and educational institutions – through multi-disciplinary teamworking.
- Improving the accessibility, quality and effectiveness of services dealing with young people – setting up counselling services with a holistic approach to young people, whilst at the same time allowing access to parents and other adults:
- Organising programmes for promotion of responsible behaviour and healthy life styles.
- Taking into account the SLSP findings, special attention will be paid to mental health programmes.
- The PRSP emphasizes the need for NGOs to take part in this area since the poor often hesitate to turn to health services, since, among other things, they believe that they have to pay extra “under the counter” for every service, while providers of health services themselves often lack the resources to identify and fulfil the needs of the poor.

## **7.5. Education as the Function of Poverty Reduction**

- 1. The importance of education for the alleviation of poverty** is convincingly demonstrated by the SLSP findings, showing that 69% of the poor in Serbia have only primary and uncompleted secondary education while only 2% of the poor have higher education. Low expenditures for education (3.14% of GDP) have a negative impact on the accessibility of education to children from poverty stricken groups and on the quality of education.

Although the official rate of enrolment in primary school is 98.3% (for 2000/2002) and the official dropout rate is 0.62%, the actual dropout rate is estimated to be nearly 15%. The problem is most prevalent among the rural population, the Roma, children with special needs, refugees and internally displaced persons. It is evident that the dropout rate is higher in girls from the most vulnerable groups: children with special needs, the Roma and the rural population.

Children with special needs constitute 7 to 10% of the overall number of school age children. However, only 1% of the whole student population of primary school age attend special schools. About 15% of the children with special needs attend special schools. The rest either attend regular schools but without any special support or are outside the education system. Only 1% of children with special needs of pre-school age are included in education and other forms of work.

32% of Roma population are illiterate or have less than 4 grades of primary school. The women’s share among the uneducated and the illiterate is higher due to early marriage and the orientation towards housework. Children from poor families often do not complete primary school, thus producing new generations of uneducated and poverty-stricken Roma. Estimates show that only about 4% of them finish secondary

schools (mostly vocational ones of lesser rank), while only 0.3% of the Roma attend high schools or universities.

Adult education is quite neglected in Serbia. Formal education is practically inaccessible to adults (at present there are only 19 schools for primary education of adults). Furthermore, they are not geared to meeting the needs of the labour market.

Causes of high unemployment in Serbia can partly be found in the existing educational structure, and in particular in the fact that secondary vocational schools are not in keeping with contemporary market demands. The curricula are too general, without enough vocational subjects, lacking a minimal or nonexistent focus on IT literacy and only basic entrepreneurship knowledge.

**2. The improvement in the effectiveness of the educational sector for the alleviation of poverty** includes the following objectives, measures and activities:

- The reform of pre-school school education includes programmes (for both children and teaching staff) aiming to cover as many children as possible through provision of regular, free of charge, pre-school education for at least one year. The programmes are intended for refugee and Roma children, children with special needs, those from rural areas as well as children from poor families.
- The new System Law on Education (2003) extends compulsory education to 9 years which, through new, goal-oriented programmes, ensures functional language skills, mathematics, scientific, creative and health literacy for the whole population. The abolition of physical fitness as one of the criteria for enrolment in a primary school will make the educational system more accessible to children from vulnerable groups. The Categorization Commission will have an advisory role.
- Raising the number of children with special needs included in the education system, especially into education of inclusive type will be effected through the following:
  - Adoption of the law and regulations concerning compulsory education of this category of children;
  - Establishing the National Centre for Care of Persons with Special Social Assistance Requirements, whose inputs will be used for the elaboration and implementation of education, health and material and social assistance policies;
  - Securing greater coverage of children with special needs, especially their greater inclusion in regular schools;
  - Teaching functional literacy to adult persons with disabilities;
  - Bringing education into line with the labour market requirements, together with legal provisions that a certain number of work places should be set

aside for this category and the provision of tax relief for employers who take on a person with a disability.

- Raising the general educational level of the Roma is of great importance for their employment, increases in their standards of living, social integration, and improved health and social protection for Roma children.

Broad inclusion of Roma children into all levels of education will be ensured through the support of Roma teaching staff, support for Roma university students at teaching faculties, integration of Roma culture into curricula, creating an atmosphere of acceptance and support of Roma children and young people with mutual tolerance and acceptance of differences.

These objectives will be achieved through the following measures and activities:

- professional and material assistance for Roma parents,
  - professional and material assistance for institutions and the employees,
  - cooperation with Roma community and developing partnerships in the implementation of programmes,
  - intersectoral cooperation with all relevant state and local institutions,
  - intercultural elements in educational programmes and institutions,
  - using the experience and best practices of NGO programmes for education of Roma as well as raising capacities,
  - developing relevant programmes of second chance education for children who have dropped out, as well as special support for the education of girls.
- Increased inclusion of adults in the educational system will be achieved through changes in legal regulations as well as the establishment of the Fund for Primary Education of Adults, offering a free of charge basic qualification for the first occupation or for professional training, thereby improving employment chances. Special programmes will be developed to suit the specific needs of the adults involved in education (distance learning, mentoring work, instruction and home consultations).
  - The PRSP also places great significance on the improvement of the working qualifications of the unemployed. At present there are 348 thousand unskilled workers in the labour market and a further 143 thousand employed. The formal school system needs to be adapted to help meet the needs of the market economy through the establishment of centres for education and training, additional qualification and re-training in keeping with the needs of the labour market. Priority is given to supporting young people who are at risk of dropping out. An alarmingly high number of primary and secondary school dropouts appear in the labour market as unskilled workers.

## 7.6 Regional, Rural, Urban and Housing Aspects of Poverty

### 7.6.1 Regional Aspects of Poverty Reduction

#### 1. Serbia is among the European states with the largest regional differences in development level.<sup>2</sup>

The emphasis on sectoral programmes over structural and territorial criteria during several decades brought about uneven development, inefficient regional distribution of economic activity and population, polarisation of broad areas, i.e. a significant disparity between municipal centres and rural areas concerning the level of development.

Underdevelopment and the overall backwardness of large areas of the Republic can be attributed to four main factors: a) rural depopulation; b) interregional differences in demographic factors; c) atomisation of settlements in underdeveloped rural areas; d) inadequate educational skills and qualifications (in underdeveloped areas almost half of the unemployed are unskilled labourers).

#### 2. The main strategic policies:

- The EU accession process requires new institutional policies in the area of regional development such as the establishment of the Republic Agency for Development of Southern Serbia. The existing Republic Development Fund may also be in a position to offer new ideas for the stimulation of regional development, including underdeveloped and poverty-stricken regions, providing wide technical assistance to such regions, creating conditions which will strengthen the economic interest of enterprises and entrepreneurs for investing in underdeveloped areas, improved access to credits for the SME sector that are expected to be the main lever for abolishing regional poverty.
- Local communities have important responsibilities for pooling local resources and creating a favourable environment for reducing underdevelopment and poverty, formulating development programmes and urban planning, stimulating the development of MSP and entrepreneurship, cost-effective management of space, development of communal/public utility services, land rent policy, construction and maintenance of local roads and improving the availability of social, health care, educational and cultural institutions to the citizens.

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<sup>13</sup> According to the Law on Underdeveloped Areas (UA) of the Republic of Serbia, 37 municipalities are considered to be underdeveloped regions, including the 12 least developed municipalities. A municipality is considered to be underdeveloped if it falls below the line drawn at 50% of the republic average concerning the following parameters: income per capita, employment rate, retail turnover per capita and the number of telephone lines per 100 citizens.

### **7.6.2 Rural Aspects of Poverty Reduction**

Almost half of the population of Serbia lives in rural areas, which constitute almost three quarters of the national territory. For decades, this part of the population has been living under conditions of economic and cultural stagnation, a situation which drastically exacerbates poverty. The poverty rate for rural areas is 14.2%, which means that one in seven people is poor. The rate of poverty in rural areas is twice as high as that in urban areas (7.8%). It is highest in Southeastern Serbia at 22.7%.

The main reasons for higher rates of poverty in rural areas are: the aging of the population through a reduced pool of active workers and the opportunity to generate income, relatively low educational achievement, as well as disadvantageous economic structure resulting in long-term unfavourable position of farming and difficulties in restructuring the agriculture sector.

In the preceding decades the position of farming on private landholdings was exceedingly unfavourable, due to the intentional policy of redirecting income from farming into other areas, principally into industry, and the effort of the authorities to protect the standards of the urban population through low food prices. This policy was abandoned two years ago through gradual liberalisation of the foreign trade regime and the abolition of state intervention in farm producer prices. However, this could not bring about significant changes in the poverty profile of farmers in the such term, principally because of the devastation farming has suffered as well as the ageing of farmers.

#### **Objectives and strategic policies**

In addition to initiatives in the sector of agriculture, the reduction of rural poverty shall also include initiatives in various other sectors. The objective is to stimulate employment and economic growth and raise living standards in rural areas, especially in the depopulated border and mountain areas. Particular attention shall be paid to elderly agricultural workers and other vulnerable categories.

The National Rural Development Plan shall be prepared. The basic idea will include an emphasis on investment and local comparative advantage. The plan shall also consider the significance of non-agricultural employment in rural areas and distinguish between economic and social goals. Special efforts shall be put on including all line ministries, agencies and local government bodies in formulating plans, while implementation will require the co-operation and engagement of all local social partners.

An important principle will be the establishment of administrative capacities and procedures, consistent with the potential access to structural adjustment funds upon submission of formal application for EU membership.

Implementation of the abovementioned goals shall be carried out through the following activities:

Raising income and employment rate in rural areas. Support to development of SMEs; establishing producers' associations; securing market infrastructure; improved processing and marketing of agricultural products; development and diversification of economic activities; development of forestry (including afforestation and wood processing). The emphasis shall also be placed on professional training.

Improving health care, education and social services. The objective is to provide higher quality services in small towns to serve the inhabitants of neighbouring rural areas.

Improving infrastructure. The focus shall be on the improvement of public transport and securing reliable water supplies in rural areas, with a gradual improvement towards EU standards in terms of water quality; providing capacities for processing waste water (this will have a positive impact on environment protection) and the building of waste management plants (in household and industry).

### **7.6.3 Urban and Housing Aspects of Poverty Reduction**

According to the SLSP, the urban population of Serbia is has a lower poverty rate (7.8%) than the rural population (14.2%). The worst situation is in old industrial centres: Kragujevac, Bor and other larger cities. Here, the restructuring process and privatisation of large non-profitable companies have produced large redundancies and new pockets of poverty.

As previously discussed, urban poverty includes all significant forms of poverty: unemployment, limited access to health care, education, etc.. This is why the PRSP focuses on **spatial aspects of poverty**, covering housing poverty and poverty-affected city districts (quarters, localities) where many forms of poverty are concentrated.

Most poor people in urban areas do not have a safe roof over their heads since their apartments lie on public land, not intended for housing, built without building permits or rented without proper rental agreements.

#### **Alleviating Urban Poverty**

Every city in Serbia should formulate its own strategy for reducing poverty based on the republic strategy while at the same time taking into account specifics and the economic and social identity of each city.

It is necessary to adapt existing town plans and to develop new ones, integrating the strategy for reducing urban poverty in all of its aspects, as well as providing sufficient building land for future housing. Such a policy can help bring the prices of building plots down, making them accessible to the poor. At the same time it is also a way to reduce unplanned, illegal construction.

The new Law on Planning and Construction (2003), among other things, provides for simpler procedures for getting building permits and allows cities to set aside land for cheaper housing construction. The law also provides for the legalisation of all illegally erected buildings.

Small loans will be granted for phased construction or reconstruction of apartments. Providing for the safety of housing through establishing defined property, legalisation of the existing houses and setting aside cheap locations for new construction will ensure better conditions for the urban poor.

### **Housing as a Factor in Poverty Reduction**

Housing problems are closely connected to poverty since the poor have to pay for the most expensive housing in relative terms. The problem of the accessibility of housing to the poor should be dealt with through social housing programmes. The work on the 'National Housing Policy' is underway to include:

- construction of social housing for vulnerable groups which cannot buy or rent a flat on the market, with availability for accessing such housing based on income and means testing of households. These flats will be built more cheaply costs, with lower standards, modestly equipped and of modest size per an individual, intended for the poorest social classes.
- Subventions by the state for housing of the most vulnerable groups on the basis of income and means testing. Most subventions are intended for rental housing either in social flats or in privately owned housing.

### **7.7 Environmental Aspects of Poverty Reduction**

1. The poor, particularly women and children are most affected by environmental problems. These are the spheres where traditional environmental dangers play a key role: lack of drinking water and sanitation, indoor air pollution and exposure to illness-causing bacterial and viral agents. Among vulnerable categories, the Roma minority has the highest risk. The poor are also more exposed to risks of floods and earthquakes, first of all because they live in areas close to river banks and secondly because their living accommodation is poorly constructed.

2. Providing sustainability of the environment is one of the eight UN Millennium Development Goals (MDG). In Serbia there is a need to improve all spheres of development goals: sustainable access to drinking water and improved access to sanitation, sustainability of the environment concerning air pollution, use of land, management of forest resources and retention of biodiversity.

In 2002 the Government of the Republic of Serbia promoted the body in charge of environmental protection from the directorate level to the ministry level. The new Law on the Environment awaiting adoption, aims at the development of a consistent and updated

legal and institutional system of environment protection. The Law will be consistent with EU standards.

### **Strategic action, measures and activities**

#### *Improvement of the water supply system*

The Water Supply Strategy for Serbia defines the basic strategic aims and priorities for improvement in the water supply system.

The Ministry of Agriculture and Water Utilities sets the priorities for village water supply. The majority of investments are small and they include improvements in sanitary conditions or building of new wells, widening and repairing of water pipes, and the construction of a chlorinisation system.

In the last two years international financing institutions have initiated projects for water supply and wastewater in medium sized towns as well as in rural areas that will address the most serious problems.

The water resource sector is not financially independent. Nowadays income from water supply services are insufficient to meet operational costs. It is necessary to measure water consumption by metering, to implement price reform and to increase the basic tariff in order to address financial problems.

#### *Improvement of sewage system*

The level of connections to sewage system in towns is 87.5% and only 22.2% in villages. Villages mostly rely on septic tanks which are in most cases illegally built and located. In Serbia there are 37 central plants for the treatment of wastewater. 7 of them are for primary treatment and 30 are for secondary and biological treatments. Only 12% of wastewater is treated in Serbia.

#### *Cleaning black spots in Serbia*

Bilateral donors have contributed to the cleaning up of the environment in several black spots, above all in the places damaged by NATO bombing (Pančevo, Novi Sad, Bor, Kragujevac). About \$21 million are needed for project implementation. So far, donors have provided US\$12.5 million and 16 projects are being implemented. In addition, decontamination projects are underway in the South of Serbia where munitions with depleted uranium were used, as well as cleaning areas of cluster bombs.

In addition, ecological black spots that are not the result of the bombings have been registered (e.g. thermoelectric power stations) and significant funds and time for their repair are needed.

## 8. Costs of the Poverty Reduction Strategy

### 8.1. Ensuring a sustainable fiscal framework for poverty reduction

An effective public fiscal management process is critical for ensuring the success of PRSP implementation. In particular, the budget and fiscal management system should be the main tool through which public expenditure implications of PRSP policies are translated into budget activities.

Substantial fiscal adjustment has taken place in recent years within the context of the stabilisation programme begun by the government in 2001. Fiscal adjustment involves redefining the role of government (away from being the direct producer of goods and services towards providing social benefits, investing in and maintaining economic infrastructure and establishing a legislative and regulatory framework for private sector activity), incorporating all public sector expenditure into the budgetary process, reducing budgetary arrears and fiscal gaps in entitlement programme, as well as increasing revenue mobilisation.

The purpose of this fiscal adjustment has been to constrain the fiscal deficit. Subsidies to enterprises and capital investment have been reduced, whilst transfers to the population, in the form of social benefits, have increased in importance. Nonetheless, implicit subsidies to enterprises and the public remain partly in place, particularly in energy.

**Table 1. Consolidated public expenditures - functional classification**

	% GDP		
	2001.	2002.	2003.
<b>I Total expenditures (1.+.....+10.)</b>	39,3	45,9	45,9
<b>General public services</b>	4,4	5	5
<b>Defence</b>	3,6	3,4	3,3
<b>Public order and safety</b>	2,6	2,7	2,8
<b>Economic affairs</b>	3,8	4,3	3,5
<b>Environment protection</b>	0	0,1	0,1
<b>Housing construction and utilities</b>	2,6	3,6	3,4
<b>Health care<sup>14</sup></b>	4,6	5,2	5,3
<b>Recreation, culture and religion</b>	0,5	0,6	0,7
<b>Education</b>	2,7	3,4	3,8
<b>Social protection and pensions</b>	14,5	17,6	18

<sup>14</sup> According to the estimate of World Bank experts, the health care expenditure share in GDP exceeds 6%, if the additional forms (such as health care expenditures at the local level and within the defence system) were included. This is above the average for Central and East European countries set at the level of 4.7% of GDP. Precise estimates of out-of-pocket health expenditures are still missing, though some surveys conducted on a small sample indicate that these expenditures range between 2 and 4% of GDP.

At just over 45% of GDP, the share of public expenditures in Serbia closely corresponds to the level that successful countries in transition (Hungary, Czech Republic, Poland, Slovenia and Slovakia) had in the mid-nineties.

Total expenditures for the protection of the poor in Serbia equal approximately 4% of GDP, which is close to the average value of countries in transition

### **Maintaining Medium Term Fiscal Stability**

The Government's medium-term fiscal policy is to maintain fiscal stability through further fiscal tightening, ensuring better use of existing resources, increasing revenue mobilisation, and providing tax incentives and other reform measures designed to stimulate business activity.

PRSP priorities (e.g. increased share of expenditures for education) are reflected in the medium-term expenditure allocations.

**Table 2. Consolidated public expenditures – functional classification**

	% GDP							
	2003.	2004.	2005.	2006.	2007.	2008.	2009.	2010.
<b>I Total expenditures (1.+.....+10.)</b>	45,9	45,6	45,2	44,8	44,3	43,9	43,5	43,1
<b>1. General public services</b>	4,2	4,5	5	5,4	5,7	5,8	5,9	5,9
<b>2. Defence</b>	3,8	3,3	2,9	2,5	2,3	2,2	2,2	2,2
<b>3. Public order and safety</b>	2,8	2,7	2,5	2,3	2,2	2,2	2,1	2,1
<b>4. Economic affairs</b>	3,5	3,4	3,2	3	2,9	2,8	2,7	2,6
<b>5. Environment protection</b>	0,1	0,2	0,2	0,2	0,2	0,2	0,2	0,2
<b>6. Housing construction and utilities</b>	4,1	4,1	4,1	4,1	4,1	4,1	4,1	4,1
<b>7. Health care</b>	5,3	5,3	5,4	5,5	5,5	5,6	5,6	5,6
<b>8. Recreation, culture and religion</b>	0,5	0,5	0,5	0,5	0,5	0,5	0,5	0,5
<b>9. Education</b>	3,6	3,8	3,8	4	4,2	4,3	4,5	4,5
<b>10. Social protection and pensions</b>	18	17,8	17,6	17,3	16,7	16,2	15,7	15,4

### **8.2. Strategy costs, resources and priorities**

The total amount of consolidated Government expenditure to be allocated for PRSP priority sectors is approximately 1.9% of GDP annually (YUD 26.6 billion or 362 million euro on average) over the next three years, out of the approximately 45% of GDP

accounted for by public expenditure. The priority PRSP sectors include employment and SME development, education, health care, and social protection. Financing of these sectors for PRSP activities would take place through increases in planned allocation of budgetary resources in relation to GDP (e.g. education) and through cost savings made within the sector (e.g. savings on the wagebill, reallocation of existing resources and reductions in overall employment).

The allocations are intended to reflect the costs of meeting the highest priority of the newly prioritised activities contained in the PRSP which currently lack financing;<sup>15</sup> they do not represent the full cost of all proposed PRSP policies.

Since new PRSP activities will be financed largely within existing resource levels, including already committed or programmed external project financing, sector ministries and local administrations will need to restructure their existing budgets, reducing the

**Table 3. Poverty Reduction Strategy Costs in the period 2004 - 06**

	<b>Central and local budgets and donations % of GDP, yearly average</b>	<b>Central and local budgets and donations million EUR</b>	<b>PRSP cost structure by sectors</b>
<b>TOTAL</b>	1,91	1.087,3	100
<b>Social protection</b>	0,28	157,2	14,5
<b>Education – total</b>	0,58	333,2	30,6
<b>Health care</b>	0,30	170,2	15,7
<b>Employment and SME development</b>	0,42	238,5	21,9
<b>Decentralisation, local and public government</b>	0,05	30,0	2,8
<b>Regional development</b>	0,05	29,3	2,7
<b>Rural poverty</b>	0,06	35,0	3,2
<b>Urban poverty</b>	0,12	70,3	6,5
<b>Environment protection</b>	0,01	5,8	0,5
<b>Human rights and gender equity</b>	0,03	16,7	1,5
<b>Monitoring and evaluation</b>	0,00	1,0	0,1

<sup>15</sup> In other words, the stated costs are marginal costs, i.e. incremental costs required due to the expansion of current activities or to the introduction of new activities, not total costs in a certain sector (social protection, education etc.)

costs of some services (efficiency savings) and making cuts in other, lower priority services. However, this will be a difficult task. Thus, in the medium term, ministries and local administrations will aim to develop the tools and capacities to restructure their budgets in order to facilitate the achievement of PRSP objectives.

**The principles behind the allocation of resources shown in the costing section in the PRSP include:**

- Emphasis is placed on savings and rationalization in the functioning of ministries, local governments and other state bodies
- Stated are marginal costs, i.e. incremental costs due to the expansion of current activities or to the introduction of new activities, not total costs in a certain sector (social protection, education etc.)
- Allocations are defined in such a way as to enable gradual achievement of the set goals in line with the overall macro/fiscal framework.
- The share of domestic fiscal resources in the overall resources for PRSP implementation is rising, in accordance with the goal for Serbia to become able in the medium-term period (till the end of this decade) to solve the poverty problem on its own.
- The importance of maintaining balance between resources intended for mitigation of poverty consequences (social protection) and those earmarked for eradication of poverty causes (education, health, employment and SME development etc.).

**9. Implementation, Monitoring and the Consultative Process of PRSP Development**

**9.1 Implementation of the PRSP**

By adopting the PRSP Strategy, the focus shifts from planning to action – a critical phase which represents a challenge for most strategic processes.

An effective implementation system would encompass the following:

- Relevant line ministries, Government institutions and agencies will be responsible for the implementation of measures and activities included in the PRSP. The development of action plans and programmes in the coming time period will facilitate a more effective implementation process, clearer definition of responsibilities and easier monitoring of the process for all relevant stakeholders. It is necessary to strengthen communications amongst those in central and local government in charge of (i) the budgetary process; (ii) co-ordinating external assistance; (iii) the process of European integration; and (iv) public administration reform. Concrete steps discussed at the ministry level are linked to the creation of a team which would be in charge of PRSP implementation, strengthening

capacities for utilising the budgetary process in planning and developing programmes, the more efficient use of human resources, etc.

- Central functions / units for monitoring and managing the implementation of the PRSP will be developed within the cabinet of the Prime Minister / General Secretariat of the Government. The aim is to develop the function in accordance with a recently initiated process of strengthening the central coordination mechanisms of the government. The Government will be regularly informed of the development of the process, problems and challenges, changes in priorities, recommended actions, etc.
- In all parts of the Strategy the importance of involving local governments in the process of identifying problems and policies has been stressed, and the same applies to the process of planning and implementation. Although there have been initiatives for strengthening the local self governments there is still a long way to go in this regard. There is also a need for better coordination of the existing initiatives for the purpose of exchanging experiences for greater synergies effect.
- As was the case with the development of the PRSP, all interested participants will define their role in the implementation and in the monitoring and evaluation of the results of the PRSP.

The link between the PRSP and the criteria in the EU Stabilisation and Association Process, as well as the UN Millennium Development Goals, has been explicitly stated in the measures and activity matrices.

Having in mind the importance of a close connection between the PRSP, the process of European integration and use of budgetary resources and external aid, the possibility for developing joint mechanisms for managing the implementation of the Strategy will be explored.

## **9.2 Monitoring the Implementation of the Poverty Reduction Strategy**

Successful monitoring and evaluation of PRSP outcomes requires the following: firstly, defining the set of (outcome and process) indicators harmonized with Millennium Development Goals; secondly, modernization and reorientation of the existing statistical system to the new requirements; thirdly, organizing the monitoring of PRSP implementation; and fourthly, active participation of the Parliament, civil society, and other relevant stakeholders in the monitoring of the PRSP.

The number of the poor, as a basic poverty indicator, will be established based on the national poverty line according to the methodology applied in the SLSP. The basic set of indicators which bring out other (non-economic) dimensions of poverty (e.g. health, education, gender equality...) was harmonized with the Millennium Development Goals, and complemented by additional indicators of specific importance for Serbia. This provided international comparability and the possibility to apply international best

practice. Apart from the outcome indicators, process indicators, which enable the monitoring of the PRSP implementation, have also been included.

Successful monitoring of the PRSP requires further development and modification of the existing system of statistical research. The Republic Statistical Office, which is currently undergoing a process of modernization of the whole system of statistical research, will take on part of the work. The development of alternative systems for data collection, with the considerable participation of civil society and vulnerable groups, has also been envisaged.

It is envisaged that the relevant ministries will form sectoral working groups in charge of monitoring and evaluating the results of sectoral PRSP activities. It is also envisaged that a special working group as part of the Republican Statistical Office will be formed. At the local level, municipal working groups in charge of monitoring the PRSP will be formed and will involve representatives of civil society and vulnerable groups, as part of the socio-economic councils.

The formation of civil society and international development partners' working groups has been planned. Active inclusion of civil society in monitoring of the PRSP shall be secured through the creation of local NGO monitoring networks and the development of appropriate methods of participatory PRSP monitoring.

The Central Team for Monitoring PRSP Implementation. and Outcomes will have a special function (communication with the PRSP Implementation Management Unit, coordination of all monitoring working groups, collection of working groups' sectoral reports and preparation of synthesized reports on strategy implementation and results, coordination of sectoral teams, communication with the media, etc.). Working groups within the PRSP monitoring system shall each have a representative in the Central Team for Monitoring PRSP Implementation.

### **9.3 Poverty Reduction Strategy Consultative Process**

One of the important elements for formulating the PRSP was a widely established and flexible consultative process, including the participation of all relevant stakeholders. The institutional and organizational structure for the development of the PRSP in Serbia was open and included the PRSP Steering Committee (SC), composed of nine ministers and chaired by the Prime Minister, as well as seven representative Advisory Committees (AC), including representatives of the National Assembly, civil society, local government, labour unions, business community, inter - ministry and international development partners' Advisory Committee. An Advisory Board was also formed, consisting of representatives from the Advisory Committees, the Expert Task Force and the Government. Its main task was to disseminate information, coordinate and consolidate comments provided by the different Advisory Committees and to present recommendations and conclusions to the Steering Committee based on these. The Expert Task Force (ETF), consisting of 29 experts in different fields, was mainly in charge of drafting the PRSP, based on consultations with the Advisory Committees, outputs of the

consultative / participatory process and instructions from the Steering Committee and different ACs. The PRSP Management Unit was a specially formed Unit within the Ministry of Social Affairs with the aim of providing organizational support to the PRSP preparation process, and coordination of the work of the experts as well as the wider participatory process.

The PRSP development process consisted of five phases: 1) institutional set-up; 2) development of the framework for the PRSP; 3) first draft of the PRSP; 4) second draft of the PRSP; and 5) final draft and the full PRSP.

In addition to numerous bilateral meetings with representatives of relevant stakeholders in the process, the Strategy was presented in different forms and in a great number of cities and municipalities through around 80 meetings and forums with over 3,300 participants.

Serbia's experience in PRSP preparation has shown that a wide consultative process has provided an opportunity for social actors that have not previously been included in the preparation of strategic documents to contribute with their comments and suggestions to the creation of a joint, nationally owned Poverty Reduction Strategy.

### **PRSP Local Initiatives**

The aim of the Local Initiatives was to strengthen national ownership of the PRSP through pilot projects. During July and August, 2003, 27 local initiatives were implemented in Serbia with the aim of strengthening national ownership. This was realised through support to initiatives "from the local level" which implemented different activities in around 40 municipalities and over 100 country villages with the aim of enhancing local community participation in the process of development and implementation of the PRSP. This mechanism will be used in the implementation and the monitoring process of the PRSP.

### **10. Poverty Reduction Strategy – Priorities**

The PRSP process represents an integral part of the continuation of economic reforms and the establishment of rule-of-law state and democratic institutions. The strategy has a developmental orientation taking into account the numerous fiscal and other limitations and risks linked to the first phase of transition in Serbia.

Alleviation of poverty does not concern only material subsistence and the realization of human rights – it also includes the creation of equal opportunities for all in the field employment, education, health care and social protection. The PRSP therefore focuses on the efficient implementation of the defined poverty reduction programmes, both across different sectors and in relation to the most vulnerable groups which have been identified.

In view of the main strategic aims of the PRSP, poverty reduction priorities as early as 2004 will be:

- In the field of **employment**, the priority is improving the educational and qualification structure of the unemployed and youth, in addition to entrepreneurship and SME development.
- In the field of **social protection** an emphasis is placed on improving protection of vulnerable groups (both in terms of coverage and the amount of assistance) and expanding the range and quality of social protection services.
- In the **health sector** special health care programmes targeting vulnerable groups will be defined, together with a more efficient allocation of resources with a particular focus on primary and preventive health care.
- In the area of **education** the priority will be to implement educational reform in line with the requirements of the market economy and the development of the private sector alongside the full inclusion of the vulnerable groups into the formal education system.

The implementation of the PRSP will contribute considerably to reducing poverty in Serbia. The speed of poverty reduction will depend on the availability of fiscal allocations, which to a great extent depend on future economic growth (projected to be 4-5% per year). Under those conditions and assuming no growth of inequality in the distribution of incomes, the poverty rate in Serbia would drop to around 6.5% by the year 2010. On the other hand, greater external assistance, targeted to PRSP priority areas, would assist in a faster reduction in poverty.

Apart from considerable financial resources, the successful achievement of these PRSP objectives also requires the sincere willingness and readiness of all stakeholders to take an active and responsible role in the implementation of the Poverty Reduction Strategy.

## **ACTIVITY MATRICES**

**Situation Analysis, Policies and Activities, Timeframe, Likely  
Poverty Impact, Implications for Public Expenditure**

## Macroeconomic Framework and Factors of Sustainable Economic Growth

**Millennium Goal<sup>16</sup> 1: Eradicate extreme poverty**  
**Millennium Goal 8: Develop a global partnership for development**

Related SAP<sup>17</sup> Objectives:

N/A

Related PRSP Main Directions:

I. Economic growth

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>Basis for medium-term macro stability put in place.</p> <p>Monetary policy directed towards controlling inflation.</p> <p>Fiscal policy directed towards stability and fiscal reform.</p> <p>Reform of sales tax (abolition of sales tax on basic items) and the incorporation of benefits in gross salary calculations have benefited the poor.</p> <p>Although still moderate, the degree of inequality has a</p>	<p>Maintain medium-term macro stability to underpin sustainable economic growth</p> <p>Continue fiscal reforms and ensure fiscal sustainability of public expenditure</p> <p>Maintain inequality at least at current levels</p> <p>Aim for growth rate of 4-5% in the period 2004-2006</p>	<p><b>Economic growth will depend on: (i) maintaining macro stability (limiting fiscal and current account deficits to less than 3% and 10% of GDP respectively); (ii) increasing the rate of investment and domestic savings; (iii) improving export performance; and increasing the levels of</b></p>	<p>MFIN<sup>18</sup>, NBS<sup>19</sup>, MEIR<sup>20</sup>/SIEPA<sup>21</sup></p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p>	<p><u>Indirect:</u> macro and fiscal stability are preconditions for economic growth.</p>	<p>Macro and fiscal reform measures will need to be undertaken within the existing resource framework.</p>

<sup>16</sup> UN Millennium Development Goals

<sup>17</sup> Stabilisation and Association Process

<sup>18</sup> Ministry of Finance and Economy

<sup>19</sup> National Bank of Serbia

<sup>20</sup> Ministry of International Economic Relations

<sup>21</sup> Serbian Investment and Export Promotion Agency

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>negative impact on the poor. Similar level of inequality to that in neighbouring countries. Current macro position characterised by high unemployment rate, low domestic savings rate, poor export performance and a low level of investment. Large current account deficit (12% of GDP) Potentially risky public debt position, mainly from old external debt.</p>		<p><b>export-oriented foreign direct investment (FDI)</b>  Monetary policy to aim at further reductions in inflation and strengthening the external position through export promotion in areas where Serbia has a competitive advantage.  <b>Fiscal sustainability implies no increases envisaged in public expenditure/GDP.</b>  <b>Falling revenue/GDP ratio to be achieved partly through tax relief for businesses.</b>  <b>Reduced expenditure/ GDP ratio to come through cuts in subsidies and reduction of role of State in the economy.</b>  Harmonise customs, trade and indirect tax regimes with that of Montenegro, in preparation for SAA with EU.  Continue debt restructuring process – implementation of Paris Club, negotiations with London Club and regularisation of other debt, including restructuring of Russian short-term debt.  <b>Continue to implement fiscal reforms (see fiscal reform matrix).</b>  Promote export-oriented FDI</p>	<p>2004-2006  2004-2006  2004-2006  2004-2006</p>		

Assessment/ Situation Analysis	<i>Objectives and Outcome Targets, where available</i>	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
		through privatisation, with receipts to finance budget deficit. Facilitate private sector to be engine of growth (see next matrix)			

## **Ensuring a Sustainable Fiscal Framework for Poverty Reduction**

### **Millennium Goal 1: Eradicate extreme poverty**

### **Millennium Goal 8: Develop a global partnership for development**

#### **Related SAP Objectives:**

Efforts should be made to ensure fiscal harmonisation and co-operation between the various parts of the state, in order to ensure that there are no obstacles to trade within the state.

Further efforts are needed to strengthen tax administration.

Harmonized approach, throughout the SM, to the introduction of VAT is needed.

Rapid adoption of an Organic Budget Law in Serbia. (completed)

Rapid adoption of a Treasury Law in Serbia. (completed as part of Organic Budget Law)

Tax legislation in the Republic of Serbia should be adopted rapidly with a view to enhancing transparency and improving the overall fiscal situation.

Double taxation of goods moving between Kosovo and the rest of Serbia and Montenegro must be avoided

Proposed fiscal reforms, throughout the SM, should be quickly adopted and/or implemented.

Achieving a sustainable fiscal position in Serbia and Montenegro over the medium term requires a further prioritisation of public spending to make room for new inevitable expenditure burdens (debt service, social costs of transition, necessary investments in infrastructure).

Security/police and military spending should be further reduced as a percentage of GDP and public sector wage spending should be contained.

An agreement of the Serbia and Montenegro authorities with the London Club creditors is essential to settle debt servicing obligations and relevant fiscal appropriations needed in both republics, as well as progress towards future sustainability of the balance of payments.

The overall financial viability of the state and the joint institutions must be ensured.

#### **Related PRSP Main Directions:**

1. Economic growth
2. Prevention of new poverty
3. Bringing people out of poverty

<b>Assessment/ Situation Analysis</b>	<b>Objectives and Outcome Targets, where available</b>	<b>Related policies/strategies/ activities</b>	<b>Timeframe/ Responsible Institution</b>	<b>Link to poverty reduction/ likely poverty impact</b>	<b>Implications for Public Expenditure</b>
Level of public expenditures is at just under 46% of GDP - salaries and pensions hold dominant share Increasing obligations for pension payments and debt servicing, potentially crowding	To support the implementation of the twin macro goals of rapid economic growth and economic stability Long-term sustainable fiscal policy and state solvency	<b>Sustainable fiscal policy: low tax rates, low fiscal deficit, decrease in deficit/GDP ratio (to less than 3% by 2010), and gradual reduction in</b>	MFIN 2004-2006	Indirect: Fiscal stability is a pre-condition for dynamic economic growth  Indirect: Better utilisation of budgetary	The implementation of fiscal reforms will need to take place within the overall resource framework  Fiscal reforms should lead to better utilisation of

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>out other expenditures</p> <p>Largest spending in consolidated public expenditures is in pensions, health, education and general public services.</p> <p>To maintain fiscal stability, Government has kept fiscal deficit low (below 4%) in recent years.</p> <p>Expenditures on social assistance for the poor total around 4% of GDP, covering child protection and families in poverty (MOP)</p> <p>The elimination of sales tax on basic products has had a beneficial effect on the poor.</p> <p>Programme of fiscal reforms initiated, including the complete adoption of Law on Budget System and on Public Procurement. Formation of Treasury and Public Procurement Agency. Better budget reporting required to Parliament and introduction of external audit of budget.</p>		<p><b>expenditure/GDP.</b></p> <p><b>Relative increases in the share of overall expenditure going to education between 2003-2010, with reductions in expenditure shares expected in defence, public order and safety, economic affairs and social protection (in order to improve the viability of the pension system). Detailed sectoral expenditure strategies needed for health, education, defence and internal security.</b></p> <p><b>Develop and analyse medium-term fiscal parameters consistent with sectoral and sub-sectoral priorities given in the PRSP and other priority Government strategies and reflect these in the Medium-term Expenditure Framework (MTEF)</b></p> <p>Low or zero-rating of VAT may be applied to basic products</p> <p>Lower tax rates to stimulate domestic and foreign investment</p> <p>Pursue negotiations on reducing remaining external</p>	<p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p>	<p>resources will enable resources to be targeted more effectively at priority services for the poor.</p> <p><u>Indirect:</u> Improving the link between policies and budgetary allocations will enable the Government's priority poverty reduction programmes to be more consistently and more comprehensively funded.</p> <p><u>Indirect:</u> Increasing the share of budgetary allocations to the education sector will help fund specific poverty reduction programmes in this sector</p>	<p>resources and improved linkages between budgets and policy policies.</p>

Assessment/ Situation Analysis		Objectives and Outcome Targets, where available		Related policies/strategies/ activities	<p>debt.            Use privatisation revenues to cover fiscal deficit.            Continue to implement fiscal reform measures, covering:            (i) payment reforms, including expansion of Treasury operations, (ii) reform of tax administration, including establishing regional Large Tax Payers office and preparing for the introduction of VAT, improved tax audits and introduction of self-assessment; (iii) public expenditure management reforms, including budgetary planning, resource allocation reviews.</p>	Timeframe/ Responsible Institution		Link to poverty reduction/ likely poverty impact		Implications for Public Expenditure



Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>Initial restructuring of banking sector took place but process has recently slowed down</p> <p>Improvements in basic infrastructure has been assisted by external loans and credits.</p>		<p>that all privatisation proceeds flow transparently through the budget and putting in place control mechanisms in banks prior to their privatisation</p> <p>Accelerate restructuring of 50 large state-owned enterprises in readiness for privatisation.</p> <p>Improve business environment through enactment of laws on enterprises (Company Law), bankruptcy, executive procedures, FDI, and SME agency and business registration, and amendments to laws on public procurement and financial markets/securities. Pass and implement set of anti-corruption/ anti-monopoly legislation and regulation and inspectorates. Remove administrative/ bureaucratic barriers to private sector economy.</p> <p>Continue infrastructural improvements, particularly in roads and telecoms in conjunction with already committed external grants, credits and loans.</p>	<p>2004-2006</p>		

## Transition to a Market Economy: Building Strong Public Institutions

### Millennium Goal 8: Develop global relationships of partnership for development

#### Related SAP Objectives:

Global assessment of the employment and social policy legislation of the state should be done to identify priority areas of intervention and a clear legislative and administrative action plan should be established.  
The definition and implementation of employment and social policy should be coordinated throughout the state, in order to support the functioning of a single economic space within the state and ensure coherence for employers and employees.  
Particular attention should be devoted to increased administrative capacity and efficiency in the implementation of legislation.

#### Related PRSP Main Directions:

1. Economic growth
2. Prevention of new poverty
3. Bringing people out of poverty

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p><u>Public Administration Reform</u></p> <p>A number of new Laws are being prepared to modernise public administration, including Law on Public Administration and Law on Civil Servants</p> <p>A number of on-going initiatives within ministries have begun (e.g. HR management systems, project management, establishment of a change agent, building capacities in ministries, etc.), but they are not well-co-ordinated</p> <p>Not much achieved in carrying out reform of central co-ordination functions because initiatives and responsibilities have been fragmented and</p>	<p>Ensure the provision of a dynamic, efficient and transparent public administration which is well-suited to the appropriate role of Government in a market economy</p> <p>Develop the necessary capacity for successful integration into the European Union</p>	<p>Strengthen the central co-ordination mechanisms of the Government.</p> <p>Review and improve pay and grading system, including control and more efficient use of wagebill and expenditures in general.</p> <p>Improve human resources management, including introduction of transparent systems of review and appraisal, recruitment and promotion since strengthening capacity for state institutions is a precondition for successful SAA process</p> <p>Undertake restructuring based on functional reviews and use of resources for line</p>	<p>Government and relevant ministries 2004-2006</p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p>	<p><u>Indirect:</u> a more efficient public administration should improve the effectiveness and efficiency of poverty reduction programmes.</p> <p><u>Indirect:</u> reduced corruption, particularly in social services, should improve access of the poor to these services.</p> <p><u>Indirect:</u> an efficient, capable and transparent administration is a precondition for economic growth and the creation of new jobs.</p>	<p>Public administration reform should improve the cost effectiveness of public service provision.</p> <p>Limited implications for public expenditure; reform measures will need to take place with existing resource framework.</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>reforms lack clear leadership or strategy.</p> <p>Staff in public sector institutions are underpaid and have capacity constraints relative to restructured role of government in a market economy</p>		<p>ministries and central functions</p> <p>Strengthen anti-corruption measures in order to improve service delivery (health and education etc)</p> <p>Introduce information technology to improve horizontal and vertical communications within the government service</p>	2004-2006		
<p><b>Judicial Reform</b></p> <p>Judicial system in process of establishing system of norms and regulations necessary to support a modern market economy;</p> <p>However, this has led to a proliferation of imprecise and conflicting legal regulations, open to interpretation and potential abuse;</p> <p>A number of reforms are currently under way, intended to align Serbia's legal system with that of European standards, and covering Laws on Courts, Judges, Judiciary High Council, Public Prosecution and Headquarters and Areas of Courts and Public Prosecutors. The reforms aim to provide a clear demarcation for, and thus independence of, the judicial branch of</p>	<p>Ensure access to justice for poor</p> <p>Increase independence of judicial authorities</p> <p>Improve efficiency and effectiveness of judiciary</p>	<p><b>Adopt new Constitution to protect basic human rights and judicial independence</b></p> <p>Further strengthen the independence of judicial branch</p> <p>Raise capacity, professionalism and efficiency and material/technical working conditions of juridical bodies.</p> <p><b>Modernise and rationalise civil procedure, penal code, bankruptcy act, etc.</b></p> <p>Introduce new legal sub-branches, including notary public, magistrate, judiciary police, bankruptcy commissioner and ombudsman.</p> <p>Codify professional ethics.</p>	<p>MP/AL.SG<sup>24</sup>, MoJ</p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p>		<p>Reform of the judiciary will require limited additional public resources. The aim should be to investigate the possibilities of cost savings for public financing of the judicial branch.</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
government.		<p>professionalise and strengthen ethic codex</p> <p>Improve relations between judiciary and citizens through addressing corruption in judicial branch</p>			
<p><u>Local Self-Government</u></p> <p>Effectiveness of municipal service provision is affected by poorly equipped offices, discrepancies between municipal by-laws and legislation, inadequate structure and skills of staff, poor remuneration of staff and high staff turnover, poor project monitoring and low public participation.</p> <p>Process of decentralisation of government responsibility has been initiated with the passage of the Law on Local Self Government in February 2002. However, implementation has not moved forward in reality.</p> <p>Thus, there is a need to: (i) modernise the structure of local government; (ii) restructure the relationship between levels of government, including public finance (revenue and expenditure assignment); and (iii) strengthen the capacities of staff at lower levels of government, particularly in the area of social policy, on which inadequate attention is currently being paid at municipal level.</p>	<p>Reduce poverty through more locally appropriate measures and greater decision-making by lower levels of governments and communities themselves</p>	<p><b>Develop and implement a consistent strategy for poverty reduction at the municipal level, applying particularly in the area of social welfare/ assistance, education, health care and housing/urban development planning.</b></p> <p><b>Improve the relationship, including information sharing, between municipal authorities and other municipal services and organisations, including CSOs: (i) review and identify inter-sectoral problems and co-operation, and (ii) initiate strategic, inter-sectoral work with other areas in the municipality and across municipalities.</b></p> <p>Continue to improve relationships with NGOs and CSOs through continued financial and logistical assistance in the</p>	<p>MPAL.SG 2004-2006</p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p>	<p><u>Indirect:</u> more decentralised and better-integrated services should increase the appropriateness of poverty measures to local populations.</p> <p><u>Indirect:</u> Improved delivery and accessibility of services and better targeting of vulnerable groups</p> <p><u>Indirect:</u> Local governments to have increased responsibility for economic growth</p>	<p>The introduction of greater decentralisation should be preceded by a comprehensive analysis of appropriate options for revenue and expenditure assignment to all levels of government. Cost savings in the provision of public services at all levels of government should be identified.</p> <p>In the short term, the implications of the introduction of VAT on local government revenues should be studied.</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
		implementation of poverty reduction projects.			

## Transition to a Market Economy: Global and Regional Integration

### Millennium Goal 8: Develop global relationships of partnership for development

#### Related SAP Objectives:

The institutional provisions for smooth relations with international financial and economic institutions and donors must be put in place urgently.

#### Related PRSP Main Directions:

##### 1. Economic growth

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>Serbia has programmes in place with the IMF (Extended Stand-by Arrangement), World Bank (IDA, due to expire in 2004), EBRD and EIB</p> <p>Co-operation between Serbia and Montenegro improved following adoption of new Constitution in February.</p> <p>Internal Market and Trade Action Plan commits Serbia and Montenegro to harmonise trade, customs and indirect tax regimes as a pre-condition for negotiating SAA with the EU.</p> <p>Due to lack of capacity, common market institutions are still not in place</p> <p>Serbia has Most Favoured Nation (MFN) status with the EU.</p> <p>Significant administrative barriers exist in trade relations. The Foreign Trade Law will be in place as of 1 January 2004.</p>	<p>Facilitate further foreign trade liberalisation</p> <p>Work towards establishing a common market with Montenegro in the free flow of people, goods, services and capital</p> <p>Progress towards closer association with the EU.</p> <p>Strengthen specific institutions necessary for Action Plan for SAA</p> <p>Pursue membership in WTO</p>	<p><b>Policy priorities: (i) follow Internal Market and Trade Action Plan; (ii) pursue SAA for European Integration</b></p> <p><b>Introduce legal framework for common market, particularly in terms of institutions to implement a Common Market.</b></p> <p><b>Pursue agreement on SAA with the EU.</b></p> <p><b>Strengthen administrative capacity, particularly in the sectors of justice and home affairs.</b></p> <p><b>Undertake feasibility study for European Integration</b></p> <p>Continue to follow the Extended Standby Agreement with IMF</p> <p>Undertake negotiation of status with World Bank re.</p>	<p>MEIR, Republic Government and responsible ministries, Union Government</p> <p>2003-2004</p> <p>2003-2004</p> <p>2004</p> <p>2004</p> <p>2003-2005</p> <p>2003-2005</p> <p>2003-2005</p> <p>2003-2005</p>	<p>Stability is precondition for economic growth in Serbia. Growth contributors are integration in European mainstream and further international integration</p>	<p>Limited implications for public expenditure.</p> <p>Institutional changes will need to be made within the overall resource framework.</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
		IDA Further support to reform process, including: CARDS, preferential status, Stability Pact on refugee issues			

## Increased Employment Opportunities

**Millennium Goal 1: Eradicate extreme poverty**  
**Millennium Goal 8: Develop a global partnership for development, especially develop and implement strategies for decent and productive work for youth**

### Related SAP Objectives:

Global assessment of the employment and social policy legislation of the state should be done to identify priority areas of intervention and a clear legislative and administrative action plan should be established.  
 The definition and implementation of employment and social policy should be coordinated throughout the state, in order to support the functioning of a single economic space within the state and ensure coherence for employers and employees.  
 Particular attention should be devoted to increased administrative capacity and efficiency in the implementation of legislation.

### Related PRSP Main Directions:

1. Economic growth
2. Prevention of new poverty

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>Features: low level of employment, high unemployment rate and increasing trend, high hidden unemployment, low share of employment in private sector, low wages and low mobility of labour force</p> <p>Relative significance of non-standard forms of employment (e.g. temporary, seasonal, or occasional)</p> <p>Significant grey economy, including those more at risk of poverty</p>	<p>Creation of an efficient, competitive, open and liberal market economy, dependent on:</p> <p>More efficient and mobile labour market with a higher level of human capital</p> <p>New employment opportunities (reduction of grey economy and SMEs) in order to reduce unemployment</p> <p>Increased internal and external demand will be the engine for growth</p>	<p><b>Creation of new job opportunities</b></p> <p><b>Develop incentives for private sector to create new employment opportunities – elimination of obstacles for business and improving competitiveness, reducing the grey economy (see judicial reform matrix), stimulation of domestic and external</b></p>	<p>MLE<sup>25</sup>, MEP, SME agency, Employers' Association, trade unions, local communities</p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p>	<p><u>Direct</u>: increased employment opportunities will help raise the living standards of the population, particularly those currently unemployed or facing unemployment.</p> <p><u>Direct</u>: direct employment training and job counselling services will improve the prospects of those with skills of limited</p>	<p>The introduction of labour market programmes will need to be phased in according to the availability of resources.</p> <p><b>The participation of the business community in the improvement of skills should be promoted.</b></p> <p>Legalisation of grey economy will lead to stronger control of public revenues and more resources available for</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>Qualification/skills of unemployed tend not to correspond to qualifications and skills required by market economy. Relatively low educational qualifications of unemployed.</p> <p>More than one-third of unemployed have been unemployed for more than 1 year</p> <p>Vulnerable groups (including women and youth) predominate over other groups in overall unemployment, e.g. unemployment rates amongst refugees, IDPs, Roma and disabled are double those of the population as a whole.</p>	<p>Increased employment opportunities for vulnerable groups</p>	<p><b>Investments</b></p> <p><b>Stimulate economic growth and employment at local and regional levels, including export-orientated FDI and increased public and private investment (regional development matrix)</b></p> <p><b>Open up economy to regional and global markets through WTO, free-trade agreements and European Integration process (see Global and Regional Integration matrix)</b></p> <p><b>Develop SME sector: create framework for sustainable, internationally competitive and export-oriented SME sector</b></p> <p><b>Sustainable development of the private agriculture sector.</b></p> <p><b>Target employment measures to vulnerable groups, including social programmes such as public works, micro enterprises, and employer subsidies (see regional development matrix)</b></p> <p><b>Develop a more efficient</b></p>	<p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p>	<p>marketability.</p> <p><u>Indirect</u>: More efficient and transparent labour market will improve the efficiency of resource allocation, e.g. services, agriculture and certain industries</p> <p>Preconditions of growth are macro stability and a dynamic private sector for more rapid employment</p>	<p>priority areas.</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
		<p><b>labour market</b></p> <p>Promote active employment measures (targeted), improving quality of supply through vocational training, and increased labour mobility</p> <p>Begin development of a new Law on Employment regulating benefits for unemployed workers</p> <p>Improve system of counselling and mediation between employers and employed: annual job fair in each branch office of the National Employment Service</p> <p>Human capital development (linked to vocational training in education sector)</p> <p><i>Improved capacity of Labour Market Bureau (National Employment Agency)</i></p>			

## More Efficient Social Protection

### Millennium Goal 1: Eradicate extreme poverty

#### Related SAP Objectives:

Global assessment of the employment and social policy legislation of the state should be done to identify priority areas of intervention and a clear legislative and administrative action plan should be established.

The definition and implementation of employment and social policy should be coordinated throughout the state, in order to support the functioning of a single economic space within the state and ensure coherence for employers and employees.

Particular attention should be devoted to increased administrative capacity and efficiency in the implementation of legislation.

Legislation should be enacted to fully ensure the social security of migrant workers within the state, notably regarding the transferability of pension rights.

Reliable statistical data should be collected on poverty in order to assess the situation.

The efficiency of social security should be increased, notably through improved targeting of the neediest parts of the population

#### Related PRSP Main Directions:

3. Bringing people out of poverty

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p><u>Social assistance</u></p> <p>MOP</p> <p>The social assistance programme MOP has limited coverage, its regulations are restrictive, well targets the poorest people, favours small families and mainly covers those with a poor educational background, the unemployed, and persons with disabilities</p> <p>Increase in MOP recipients from 67,000 in 2000 to 125,000 in 2002, boosted by external grants and improving the timeliness of transfers</p>	<p>To widen the provision of social protection, through paying higher amounts of assistance and widening the social safety net to include those most vulnerable groups (e.g. Roma, ex-refugees) currently ineligible for social assistance</p> <p>Ensure access for all who are eligible for social protection but are currently not participating, including Roma, refugees who will become citizens, IDPs, etc.</p>	<p>Emphasise new government role in reformed social protection system: limited to developing legislative framework, oversight and provision of a basic safety net for social insurance and assistance.</p> <p><b>Enhance equity and coverage of MOP, child social assistance programmes through: (i) applying uniform income test line as criteria for social assistance; and</b></p>	<p>MoSA<sup>26</sup></p> <p>2004-2006</p> <p>2004-2006</p> <p>2004-2006</p>	<p><u>Indirect:</u> Measures to increase economic growth expected to reduce number of poor and depth of poverty and thus reduce the number of people requiring social assistance.</p> <p><u>Direct:</u> Better targeting measures to increase access and coverage, and improved index linking of social entitlement programmes</p>	<p>Ensuring fiscal sustainability of social services provision will be a priority.</p> <p>Review of social assistance expenditures should facilitate improvements in efficiency use, generating budgetary savings and reallocating these resources to higher priority areas.</p> <p>Expansion of existing programmes or the introduction of new ones</p>

<sup>26</sup> Ministry of Social Affairs

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p><u>Child allowance</u> Child allowance is the largest programme of assistance to the poor, specifically to poor families with children. New Law on Financial Support to Families with Children (March 2002) allows more accurate targeting of poor families.</p>	<p>Improved targeting of social services and entitlement programmes to those most in need and maintain fiscal sustainability.</p>	<p><b>(ii) introducing improved targeting and streamlining criteria to provide assistance to the poorest and those not in a position to look after themselves.</b> Increase efficiency of social protection system through better use of resources within existing budget constraints (fiscal sustainability) Promote greater role of communities in the provision of social assistance, in partnership with humanitarian, NGOs and other organisations Introduce measures to mitigate the effects of expected increased energy prices</p>	<p>2004-2006</p>	<p>will aim to provide more resources to those with the greatest need. <u>Indirect:</u> Improving the efficiency of social assistance programmes will reduce costs and enable the better use of limited resources. However, a balance should be struck between increasing efficiency and reducing access to services, e.g. in rural areas.</p>	<p>will need to be phased in according to the availability of resources.</p>
<p><u>Assistance to Vulnerable Groups</u> Because of their status, many of the most vulnerable (refugees, IDPs and Roma) are ineligible for social assistance, either because they are not citizens or do not have appropriate ID documents (e.g. lack of a permanent address) Some of those who are eligible for social assistance do not receive it because they are unaware of the programme and/or of their right/ability to participate</p>		<p><b>Increase access to social protection to refugees, IDPs and other groups through implementation of the Refugee and IDP Strategy being developed. This will involve facilitating refugees to become citizens, and facilitating IDPs and Roma to obtain documents)</b> <b>Increase access to those currently eligible but not participating through improving public</b></p>	<p>MoSA, Commissariat for Refugees and IDPs, NGOs 2003-2006 2003-2006</p>	<p><u>Direct:</u> increased access and coverage will aim to provide more resources to those with the greatest need.</p>	<p>Ensuring fiscal sustainability of social services provision will be a priority. Review of social assistance expenditures should facilitate improvements in efficiency use, generating budgetary savings and reallocating these resources to higher priority areas. Expansion of existing programmes or the introduction of new ones will need to be phased in according to the</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
		<p>relations/ communications campaigns and investigating the cost-effectiveness of streamlining administrative procedures</p>			availability of resources
<p>Social services Insufficiently developed alternatives to institutional care, including foster care Insufficient capacities of network of day care centres and insufficient developed home help for vulnerable people Poor living conditions in some institutions</p>		<p>relations/ communications campaigns and investigating the cost-effectiveness of streamlining administrative procedures</p> <p><b>Continue process of de-institutionalisation and development of alternative forms of social services, including foster care. Greater reliance on day care instead of institutional placement. Alternatives to Institutional Care (AIC) should be linked to other issues, such as health services.</b></p> <p>Continue Social Innovation Fund (SIF) programme. Improve cross-sectoral linkages between social service delivery mechanisms, focusing on the relationship between CSWs and other stakeholders in the local community (schools, health institutions, courts, police, NGOs, media etc.), highlighting the need for an integrated approach to services and emphasising the role of CSW as coordinator and mediator. Continue to develop</p>	<p>MoSA, NGOs 2004-2006 2004-2006 2004-2006 2004-2006</p>	<p><u>Direct:</u> The development of programmes specifically geared to the needs of vulnerable groups should improve their conditions of care.</p> <p><u>Indirect:</u> Improving the efficiency of social services will reduce costs and enable the better use of limited resources. However, a balance should be struck between increasing efficiency and reducing access to services, e.g. in rural areas.</p>	<p>Ensuring fiscal sustainability of social services provision will be a priority. Review of expenditures on social services should facilitate improvements in efficiency use, generating budgetary savings and reallocating these resources to higher priority areas. Expansion of existing programmes or the introduction of new ones will need to be phased in according to the availability of resources. The participation of CSOs in the wider provision of social services provision, particularly to the most vulnerable groups, should be promoted.</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
		professional standards for Social Welfare Centres			

## Improved Status of Pensioners and Elderly

### Millennium Goal 1: Eradicate extreme poverty

#### Related SAP Objectives:

- N/A

#### Related PRSP Main Directions:

- Bringing people out of poverty

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p><b>Pensions</b></p> <p>Reform of pension system began in 2001 to close the fiscal gap between responsibilities and available resources, including: (i) reducing pension contribution rate from 32% to 19.6%; (ii) increasing retirement age by 3 years to 63 (men) and 58 (women); (iii) indexation of pensions by combined index of wage growth and cost of living; (iv) single minimal net pension introduced; (v) basis of pension calculations changed to a person's whole work history; (vi) possibility of voluntary insurance was introduced; and (vii) eligibility criteria for disability insurance were tightened, and an inspection of medical committees was introduced. During 2001 and 2002 pensions were increased in real terms (average increase of</p>	<p>Raise the standard of living of pensioners and other elderly persons in terms of the number, the share and the depth of poverty. Strengthen the institutional and service provision for particularly vulnerable elderly persons.</p>	<p>Continue the structural reform of the pension system. Further re-examination of conditions for equalising the retirement position of men and women, e.g. through abolishing the general privilege for women and adopting a wide privilege for mothers, subject to the number of children. Re-examine the preferential status of certain categories of pension insurance, by restricting accelerated retirement only to special justified cases. Reform the farmers' pension fund operation, e.g. by consolidating this pension fund and paying remaining arrears to promote participation by farmers. Introduce voluntary private pension insurance, beginning with introducing relevant</p>	<p>MoSA 2004-2006</p> <p>2006</p> <p>2006</p> <p>2004-2006</p>	<p>Direct: Accelerated collection of contributions and more regular payment of farmers' pensions will raise their standard of living. Continued payment of "old debt" to pensioners will improve their living standards. The change in the basis of pension contributions to take into account the whole of a person's working history will benefit the poor.</p>	<p>Ensuring future fiscal sustainability of pension provision will be a priority. The fiscal implications of proposed changes to the pension system, such as changes to the retirement age, should be investigated adequately. The introduction of social pensions or other programmes will need to be phased in according to the availability of resources. The participation of CSOs in the wider provision of assistance to the elderly should be facilitated.</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>nearly 90% in real terms) and standard of living of pensioners increased significantly. No further arrears on pension payments are being built up. Pensioners have only a marginally higher poverty rate than the rest of the population, whilst those elderly without pensions have a higher poverty rate.</p>		<p>legislation.</p>			
<p><b><i>Social services to the elderly</i></b>  The de-institutionalisation process has begun (e.g. SIF project)  The process of turning collective centres into homes for the elderly has begun.</p>		<p>Continue de-institutionalisation process and support development of alternatives to institutional care, including day care services, personal home care provision, and other local community initiatives</p> <p>Ensure appropriate provision of care for elderly in poorer regions</p> <p>Continue conversion of refugee centres into homes for the elderly.</p> <p>Increase patient contributions for institutional care, with the amount based on location and quality of accommodation.</p> <p><b>Enable private sector provision of private accommodation for elderly.</b></p>	<p>MoSA, municipalities, NGOs  2004-2006  2004-2006  2004-2006  2004-2006  2004-2006</p>		

## Health Care Towards Poverty Reduction

**Millennium Goal 3: Promote gender equality and empower women**  
**Millennium Goal 4: Reduce child mortality**  
**Millennium Goal 5: Reduce the maternal mortality ratio**  
**Millennium Goal 6: Combat HIV/AIDS, malaria and other diseases**

### Related SAP Objectives:

**Reform the health sector and strengthen public health. Increase and improve the effectiveness of preventive programmes. Improve medicine management and establish a National Medicines Agency.**

Global assessment of the employment and social policy legislation of the state should be done to identify priority areas of intervention and a clear legislative and administrative action plan should be established.

The definition and implementation of employment and social policy should be coordinated throughout the state, in order to support the functioning of a single economic space within the state and ensure coherence for employers and employees.

Particular attention should be devoted to increased administrative capacity and efficiency in the implementation of legislation.

### Related PRSP Main Directions:

3. Bringing people out of poverty

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p><b>General Health Reform</b></p> <p>Deterioration of the country's health status over the last ten years, due to difficult macro and budgetary position, ageing population, riskier lifestyles, and poor health promotion. This has led to a widening in health indicators between Serbia and Western European countries.</p> <p>At present, the health sector is characterised by an oversupply</p>	<p>Fair and uniform access to health care for all citizens of Serbia. Decrease in inequality in access to health care, particularly for vulnerable groups.</p> <p>Provide affordable health care services for vulnerable groups and improve the quality of this care.</p> <p>Raise efficiency and effectiveness in resource utilisation</p>	<p><b>Improve the distribution of resources by health care levels and districts. This will involve a systematic review and evaluation of current health services to identify areas to improve efficiency and effectiveness. Review the current geographic distribution of health insurance funds and the</b></p>	<p><b>MoH<sup>27</sup>, Republic Health Insurance Fund</b> 2004-2006</p>	<p>Indirect: Improving the efficiency of health delivery reduces costs and enables better use of limited resources. However, a balance should be struck between increasing efficiency and reducing health access, e.g. in rural areas.</p>	<p>Modest increase in budgetary allocations to health (as % of GDP) planned over medium term</p> <p>PEM reforms should facilitate the process of improving efficiency use, generating budgetary savings and reallocating these resources within the health sector to higher priority areas.</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>of staff with low salaries, significant deterioration of buildings and equipment, a dramatic fall in the quality of medical services, a decrease in their utilisation, lack of medicines and supplies, a culture of corruption, transfer of patients and equipment from the state to the private health sector.</p> <p>Utilisation rates are affected by inadequate adjustment of the structure of hospital beds to the changed needs of the population.</p> <p>There is a growing disparity between health care entitlements and related resources. Public health care expenditure per capita has fallen from \$121 in 1996 to \$74 in 2001. The gap has been taken up by increased direct expenditure by patients/families, which has adversely affected the accessibility of health care to the poor.</p>		<p><b>activities funded.</b></p> <p>Republic Health Insurance Office is responsible for most changes in resource allocation aimed at improved accessibility of health services for poor and vulnerable groups. In order to achieve PRSP objectives, the RHIO shall increase expenditures for some services and redistribute the existing expenditures based on savings and increased efficiency in some areas, e.g. reducing expenditures for non-medical staff, advancing the public procurement system for medicines and equipment, application of protocols for cost-effective health protection etc.</p> <p>Establish distribution criteria for redistribution of available resources from the highest to the lowest level of care.</p> <p><b>Develop a basic package of health services, focussing on primary/preventive care aimed at prevention of chronic wide-spread non-communicable diseases and promotion of healthy life-styles, for both the poor who pay health insurance contributions (services funded from the Mandatory health Insurance Fund), and</b></p>	<p>2004-2006</p> <p>2004-2006</p> <p>2006</p> <p>2006</p> <p>2006-2008</p> <p>2004-2006</p>		<p>The introduction of the basic package will require sufficient public resources, which should come from the reallocation of savings from reorganising and rationalising health facilities.</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
		<p><b>those who are not insured (services funded from the Republican budget).</b></p> <p>Reform of primary health care services and restructuring of hospitals, following development of a Hospital Master Plan.</p> <p>Introduce new model of payment for health service providers (capitation), based on the principle of the money following the patient and on actual results.</p> <p>Introduce concept of private practice under standards set by professional bodies.</p> <p>Introduce health information system</p> <p>Introduce appropriate legislative changes to enable these reforms to take place.</p> <p>These include laws on health protection, drugs and medical means, Chamber of Health Workers, and Health Insurance.</p>			

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p><b><u>Targeting Health Care for Vulnerable Population</u></b>  SLSP found that vulnerable groups have higher morbidity and mortality rates than the general population from diseases such as TB, AIDS, cancer, etc.</p>		<p>Develop and implement targeted national programmes for extremely vulnerable groups, including programs for health protection of women, children, Roma refugees and IDPs, rural population.  Integrate measures for protection of vulnerable groups with regular health care programmes.  Develop and implement programs of protection against certain infectious diseases – AIDS, TB, etc.  Facilitate multi-disciplinary approach, involving health care institutions, social welfare centres, and educational institutions</p>	<p>MoH 2004 2004-2006 2004-2006</p>	<p><u>Direct</u>: More direct impact on poverty reduction through the implementation of programmes for vulnerable groups</p>	<p>The implementation of other programmes should be phased in according to availability of resources, including those freed up by efficiency savings from other areas of the health sector.</p>

## Education Aimed at Poverty Reduction

### Millennium Goal 1: Eradicate extreme poverty

### Millennium Goal 2: Achieve universal primary education

### Millennium Goal 3: Promote gender equality and empower women

#### Related SAP Objectives:

SM should continue its effort to join the Bologna Process (declaration already signed) Global assessment of the employment and social policy legislation of the state should be done to identify priority areas of intervention and a clear legislative and administrative action plan should be established.

The definition and implementation of employment and social policy should be coordinated throughout the state, in order to support the functioning of a single economic space within the state and ensure coherence for employers and employees.

Particular attention should be devoted to increased administrative capacity and efficiency in the implementation of legislation.

Develop and implement a vocational, education and training policy, improve the availability and quality of education and training. Enhance the higher education system and ensure mutual recognition of education systems to foster labour mobility.

#### Related PRSP Main Directions:

2. Prevention of new poverty
3. Bringing people out of poverty

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p><b>Education Reform</b></p> <p>General assessment</p> <p>Living Standards Study shows strong link between poverty and low educational profile. Significant reduction of total expenditures and in share of GDP for education from 1990 to present. This has adversely affected quality and access. Existing network of educational institutions does not correspond to demographic</p>	<p>To increase budgetary expenditures as % of GDP to 4.0% over medium term</p> <p>To improve material standard of education provision</p> <p>To improve efficiency and access of population</p> <p>To improve quality/training of teachers</p>	<p>Reallocate budgetary resources towards poorer regions/ municipalities (decentralisation process)</p> <p>Optimise school network: rationalisation of school use and reallocation of funds saved to building, material and equipment needs of other schools.</p> <p>Carry out education institutional needs analysis</p> <p>Provide scholarships to</p>	<p>MES<sup>28</sup></p> <p>2003-2007</p> <p>2003-2007</p>	<p>Indirect: Improving the efficiency of education delivery reduces costs and enables better use of limited resources. However, a balance should be struck between increasing efficiency and reducing education access, e.g. in rural areas.</p>	<p>Overall: increased budgetary allocations to education (as % of GDP) to 4% planned over medium term</p> <p>PEM reforms should facilitate the process of improving efficiency use, generating budgetary savings and reallocating these resources to higher priority areas.</p> <p>Budgetary resources will</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>and educational needs. Poor physical condition of buildings and equipment. Inefficiencies in education delivery hampering quality of education provision</p>		<p>students from poorer families Design and implement teacher training/ retraining programme based on current needs of sector. Introduce quality assurance measures.</p>			<p>need to be made available for improved teacher training and improved equipping schools. These could come from the reallocation of savings from reorganising/ consolidating educational institutions. This will be phased in according to availability of resources.</p>
<p><i>Pre-Primary</i> According to general assessment, relatively limited participation of marginalised groups in pre-primary education.</p>	<p>To introduce compulsory pre-school education and development of system of early childhood development To increase coverage for all cohorts, particularly for excluded groups</p>	<p>Undertake critical review and needs assessment of pre-primary sector/ early childhood development, including detailed cost implications Provide legislative framework for further reform process, including Law on Pre-School Education <b>Link state, private and NGO pre-school initiatives. Introduce good practice based on NGO experience. Study ways to improve inter-sectoral co-ordination</b> Develop alternative half-day programmes for children aged 5-7. Focus on participation of vulnerable groups (see below).</p>	<p>MES, Serbian Gov't/Parliament 2003-2004 2003 2003-2005 2003-2005</p>	<p><u>I</u>ndirect: through the correlation between poverty and educational attainment: increasing pre-primary and primary enrolment and completion rates lowers the risk of poverty.</p>	<p>Expanding pre-school education through public expenditure over the medium term will need to take place in line with the availability of resources. The participation of CSOs in the wider provision of pre-school opportunities should be investigated.</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p><i>Primary</i></p> <p>As general assessment Greatest number of poor are those with primary as highest level of education High enrolment rate</p>	<p>To prolong compulsory education from 8 to 9 years (initiated in 2003/04 school year)</p> <p>Ensure universal primary education coverage, particularly amongst marginalised/ vulnerable groups (see below)</p>	<p>Review primary education provision and curricula to improve focus on educational outcomes. Design and implement curricula reform, including relevant teacher training/ retraining.</p> <p>Extend primary coverage to 9 years.</p> <p>Review legislation related to primary education.</p> <p>Optimise school network (see above).</p> <p>Design and implement teacher training/ retraining programme based on current needs of sector. Introduce quality assurance measures (see above).</p>	<p>MES, Serbian Gov't/Parliament</p> <p>2003-2007</p> <p>2003-2004</p> <p>2003-2004</p> <p>2003-2007</p>	<p><u>Indirect:</u> through the correlation between poverty and educational attainment: increasing pre-primary and primary enrolment and completion rates lowers the risk of poverty.</p>	<p>Improving primary education through public expenditure over the medium term will need to take place in line with the availability of resources. Increased share of primary education in overall education expenditure</p>
<p><i>Secondary vocational</i></p> <p>As general assessment Lack of connection between secondary vocational schools and needs of market economy Lack of openness towards population already employed</p>	<p>To reorganise vocational education system in line with needs of economy</p>	<p>Introduce graded system of secondary vocational education.</p> <p>Expand vocational education to non-formal education and link to work experience</p> <p>Strengthen job counselling services in Employment Bureau and secondary schools.</p> <p>Design and implement teacher training/ retraining programme based on current needs of sector. Introduce quality assurance measures (see above).</p>	<p>MES, Serbian Gov't/Parliament</p> <p>2003-2007</p> <p>2003-2007</p> <p>2003-2007</p>	<p><u>Indirect:</u> through increasing the number of skilled workers in areas applicable to market needs. Should also be a focus on expanding completion rates of general secondary school to provide workers with general learning skills.</p>	<p>Expanding vocational education through public expenditure over the medium term will need to take place in line with the availability of resources.</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p><i>Adult education</i> According to general assessment, adult education is marginalized Weak linkages to labour market</p>	<p>To provide systemic opportunities for adults to gain qualifications</p>	<p>Establish a Fund to finance primary education for adults, particularly adults &lt;25 and those in rural areas. Expand adult education programmes to include distance education, tutorial system, etc. Provide appropriate materials and equipment. Include the in-formal educational system in the official Establish centre for adult education and strengthen existing centres/institutions for vocational.</p>	<p>MES, Centre for Adult Vocational Education 2004-2006  2004-2006</p>	<p>Indirect: through increasing the number of skilled workers in areas applicable to market needs.</p>	<p>Expanding adult education through public expenditure over the medium term will need to take place in line with the availability of resources.</p>
<p><u><i>Education of Vulnerable/ Marginalised Groups</i></u>  <i>Children with Special Needs</i> As general assessment Children with special needs (7-10% of children) often excluded from education system. <i>Roma</i> Drop-out rate for girls from vulnerable population (e.g. Roma children with special needs) is higher than other groups A high rate of Roma is completely/functionally illiterate. Low percentage of Roma children are in formal education (20% in primary).</p>	<p>To widen coverage and participation of marginalised groups in educational system (increasing educational attainment of Roma and other insufficiently educated groups) To encourage integration of special needs students into regular schools as much as possible</p>	<p>Provide one year of fee-free pre-school to marginalised/ excluded children and those at risk. Strengthen legislation for compulsory education of marginalised groups. Establish inter-sectoral National Centre for Care of Persons with Special Social Assistance Requirements Increase access to adult education/ literacy courses for those with special needs and other marginalised groups Provide specific support to Roma teachers <b>Introduce Roma culture into curriculum. Learn from experience of CSOs.</b></p>	<p>MES, Centre for Professional Development of Teachers, MHMR, MSA, Centre for Education of Persons Needing Special Social Support  2003-2007</p>	<p>Direct: Increased opportunity for quality employment, focussing on groups with low educational attainment</p>	<p>Budgetary resources will need to be made available for providing free pre-school education to marginalised groups. These could come from the reallocation of savings from reorganising/ consolidating educational institutions. This will be phased in according to availability of resources.  The participation of CSOs in the wider provision of educational opportunities for Roma and special needs children should be facilitated.</p>

## Addressing Regional, Rural and Urban/Housing Aspects of Poverty

**Millennium Goal 1: Eradicate extreme poverty**

**Millennium Goal 7: Ensure environmental sustainability, especially achieve a significant improvement in the lives of slum dwellers**

**Millennium Goal 8: Develop a global partnership for development**

Related SAP Objectives:

N/A

Related PRSP Main Directions:

2. Prevention of new poverty
3. Bringing people out of poverty

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p><b>Regional Poverty</b> Increased regional disparity between developed and underdeveloped regions in recent years. Trend towards rural depopulation in recent years in search of better economic opportunities.</p>	<p>Mitigate structural problems and regional differences through investment in human resources and infrastructure Ensure relevant institutional infrastructure in place for regions and local communities to develop and implement comprehensive, long-term and strategic regional development plans</p>	<p>Encourage/facilitate inter-municipality co-operation to stimulate regional economic growth Encourage municipalities to develop and implement their own regional development programme/policies. Capacity building for this. Formulate comprehensive set of regional policies <b>Encourage partnerships between local communities and civil society.</b> Introduce measures to stimulate regional development, including a development plan for South Serbia region. Provide favourable framework for investors to</p>	<p>MIER, MSTD, RBD, local governments 2004-2006 2004-2006 2004-2006 2004-2006 2004-2006 2004-2006</p>	<p><u>Direct:</u> improvements to the development of Serbia's regions will help raise the living standards of those living in underdeveloped areas.</p>	<p>The introduction and expansion of regional development programmes, including incentives for private investors to invest in less developed regions, will need to be phased in according to the availability of resources.</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p><b>Rural Poverty</b> Rural areas contain 45% of the population Poverty in rural areas is twice the level in urban areas, due to greater numbers of elderly and relatively lower levels of educational achievements and the previous price system, which kept agricultural income low. Rural poverty has proved slower to reduce than urban poverty.</p>	<p>Sustainable economic growth of rural areas Reduction of rural poverty</p>	<p>invest in underdeveloped regions, including: (i) provision of micro-sites with adequate economic/utility infrastructure; (ii) financing the development of capital investment projects and documentation; and (iii) compensate part of expenses in early production period in newly constructed production facilities</p> <p>Develop and implement integrated rural development strategy, involving: national action plan for rural development, decentralisation of activities to regional and local levels and involving participation of rural population, improving social service provision for the poor, and improving local infrastructure. Consider establishing Rural Development Agency to identify, plan and monitor initiatives in rural development.</p>	<p>MCUP<sup>29</sup>, MAWU<sup>30</sup>, MEP, MES, local governments, civil society  2004-2006</p>	<p>Direct: improvements to the development of rural areas, including economic and social programmes, will help raise the living standards of those living in these areas.</p>	<p>The introduction and expansion of rural development programmes will need to be phased in according to the availability of resources.  The participation of CSOs in rural development at local levels should be promoted.</p>
<p><b>Urban poverty</b> Urban population has a lower poverty rate than rural population Urban poor suffer from</p>	<p>Advance the economic and the overall development of cities by promoting economic activity and employment</p>	<p>At the city level, set up bodies to co-ordinate various administration sectors and carry out actions. Cities and local communities should formulate their own strategies</p>	<p>Municipal governments, local government services</p>	<p>Direct: improvements to the development of urban areas will help raise the living standards of those living in these areas,</p>	<p>The introduction and expansion of urban development programmes will need to be phased in according to the</p>

<sup>29</sup> Ministry of Construction and Urban Planning

<sup>30</sup> Ministry of Agriculture and Water Utility

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>unemployment, limited access to health care and education, and unsanitary or unhygienic settlements due to inadequate utility infrastructure and spontaneously developed settlements</p>	<p>Ensure that the needs of the poor are incorporated in urban planning.</p>	<p>for poverty reduction, based on the national strategy but taking into account specific economic and social characteristics.</p>	<p>2003-2006</p>	<p>particularly those living in vulnerable settlements.</p>	<p>availability of resources. The participation of CSOs in urban development at local levels should be promoted.</p>
<p><b>Housing</b> Housing crisis in large cities is exacerbated by the influx of refugees and IDPs, and the economic crisis which has slowed the maintenance and reconstruction of housing stock. It is expensive and difficult for the poor to have access to legal housing due to: obstacles to gaining access to land, outdated regulations and standards for housing, and the high cost of the right to use land</p>	<p>Develop and implement social housing programme, as part of National Housing Policy, currently being developed</p>	<p><b>Efficient application of the new Law on Planning and Construction (2003)</b> <b>Create legal, financial and institutional mechanisms for social housing</b> Promote construction of cheap housing units Establish credit institutions for smaller loans to be used for phased construction/reconstruction of flats. Introduce defined priority rights, legalisation of existing flats and set aside cheap locations for new construction Design and implement pilot programmes for improving spontaneously developed settlements.</p>	<p>MUC 2003-2006 2003-2006 2003-2006 2003-2006 2004-2006</p>	<p><u>Direct</u>: greater availability of affordable housing will directly raise the living standards of both the homeless and those currently vulnerably housed.</p>	<p>The introduction or expansion of social housing provision will need to be phased in according to the availability of resources.</p>

## Environmental Aspects of Poverty Reduction

### Millennium Goal 7: Ensure environmental sustainability

#### Related SAP Objectives:

N/A

#### Related PRSP Main Directions:

1. Economic growth
2. Prevention of new poverty
3. Bringing people out of poverty

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>Poor living conditions and drinking water quality have adversely affected the health of those living in urban slums</p> <p>Critical levels of poor air quality may be found in some industrial settlements.</p> <p>Lack of proper waste management, including open waste dumps, leakage from waste dumps into groundwater and inadequate or inappropriate incineration, is creating health hazards for the urban poor, particularly for Roma, refugees and IDPs.</p> <p>Vulnerable groups lack access to electricity, water, sewerage and garbage collection, thus increasing the risk of</p>	<p>Sustainable access to improved water sources and access to improved sanitation</p> <p>Improved waste management</p> <p>Improvements in the condition of ecological black spots</p>	<p>Improve water supply in rural and urban water supply services</p> <p>Investigate ways to address major pollution issues in environmental hotspots</p> <p>Develop a consistent and modern legal and institutional system for environmental protection, harmonised with the EU's framework</p> <p><b>Improve public awareness of environmental issues</b></p> <p><b>Addressing hazardous waste management issues, including:</b></p> <p>Evaluate options for hazardous waste disposal, including potential location</p>	<p>MAWU, MPNRE,<sup>31</sup> local governments</p> <p>2003-2007</p> <p>2003-2007</p> <p>2003-2007</p> <p>2003-2007</p> <p>2003-2010</p>	<p><u>Direct:</u> better living conditions for particularly vulnerable groups will be addressed through measures to improve water quality and hazardous waste management.</p>	<p>The introduction of additional environmental protection programmes will need to be phased in according to the availability of resources. The participation of CSOs in the management of environmental protection at local levels should be promoted.</p>

<sup>31</sup> Ministry for Protection of Natural Resources and Environment

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>communicable diseases. Settlements on riverbanks and poor quality housing construction exposes the poor to flood and earthquake risks.</p>		<p>for hazardous waste storage facilities, solid waste disposal facilities, and waste water treatment plants Revised existing regulations on the transport of hazardous waste, and the capacities for the enforcement of such regulations developed.</p>			

## Monitoring PRSP implementation and evaluation of outcomes

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
<p>Serbia has a developed statistical system, including numerous regular statistical surveys and publications.</p> <p>Methodological problems include inappropriate or inconsistent standards, classification, coverage, and international comparability. These problems will be addressed through the application of the new Master Plan of statistical research and the ongoing reform of the statistical system.</p> <p>Numerous previous poverty studies/analyses were conducted using incomparable methodologies.</p> <p>Non-existing analysis of multidimensional nature of poverty.</p> <p>Lack of regular quality poverty analyses and participatory research that would enable affirmation of attitudes and opinion of the poor.</p> <p>There is a need for the development of alternative data collection networks (NGO sector, local communities, etc.).</p>	<p>Establishing an efficient system for monitoring and evaluation of PRSP outcomes.</p> <p>Active monitoring and evaluation of PRSP outcomes, enabling periodical revision of the PRSP based on the outcomes.</p>	<p>Further development of the PRSP monitoring and evaluation system, including consultations with all interested stakeholders</p> <p>Elaboration of the study on the availability of data sources for the proposed set of indicators.</p> <p>Revision of the set of indicators based on recommendations presented in the study.</p> <p>Formation of PRSP monitoring working groups and other elements of the PRSP monitoring system.</p> <p>Support to the development of civil society PRSP monitoring network, training for monitoring and evaluation techniques.</p> <p>Revision of the existing research/data sources based on the recommendations of the study and on the availability of resources.</p> <p>Suggested set of research methods for PRSP monitoring and evaluation to be implemented through the civil society network (participatory, questionnaire methods as well as PETS methods for monitoring public expenditures on the local level).</p>	<p>Team for the coordination of PRSP implementation 2003 – 2004</p> <p>Central PRSP monitoring team, other actors in PRSP monitoring 2004</p> <p>All actors in the PRSP monitoring system 2004-2006. 2006.</p>	<p>Indirect: efficient monitoring and evaluation system enables adjustment to the strategy in case of slow or no progress in achieving desirable outcomes</p> <p>Indirect: PRSP monitoring and evaluation system is necessary to define responsibility and transparency in strategy implementation</p> <p>Indirect: PRSP monitoring and evaluation system enables inclusion of local community and vulnerable groups in the monitoring of PRSP implementation</p>	<p>Financing of the PRSP monitoring and evaluation system has a very limited impact on public expenditures.</p>

Assessment/ Situation Analysis	Objectives and Outcome Targets, where available	Related policies/strategies/ activities	Timeframe/ Responsible Institution	Link to poverty reduction/ likely poverty impact	Implications for Public Expenditure
		Regular research and data collection, elaboration of reports and evaluations, publishing and media communication. Preparing final evaluation			

# POVERTY REDUCTION STRATEGY PAPER FOR SERBIA

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## I. INTRODUCTION

Towards the end of 2002, the Government of the Republic of Serbia initiated the development of the Poverty Reduction Strategy Paper (PRSP) for Serbia. The initial platform, strategic options and the preparation process of this strategy and its implementation were all defined in the Interim PRSP, approved and adopted by the World Bank and the International Monetary Fund.

The PRSP, together with the Republic of Serbia Reform Programme, represents part of the overall development strategy of Serbia, within the wider framework of Serbia and Montenegro's accession to the European Union.

The PRSP is also part of the Government's Framework for International Support and Developmental Cooperation, as well as a plan of activities for the achievement of the United Nations Millennium Development Goals.

The importance given to poverty reduction by the new democratic Government of Serbia has already been clearly expressed in its first reform document "A Reform Agenda for Serbia (2001)" featuring three main objectives:

- The establishment of a modern state based on the rule of law, including the fight against corruption and organized crime;
- The revitalization of the economy through the introduction of market-oriented reforms;
- The fight against poverty and the improvement of the social protection system for the most vulnerable groups.

In line with the UN Millennium Development Goals, the PRSP defines poverty as a multi-dimensional phenomenon that in addition to representing insufficient income to cover basic needs, also includes a lack of employment opportunities, and inadequate accommodation and access to social protection, health, educational and communal services. These aspects are particularly important in the case of vulnerable and socially excluded groups. The other key elements characterizing poverty are lack of access to a healthy living environment and natural resources, above all clean water and air.

The PRSP represents a holistic plan of activities aimed at reducing key types of poverty by creating financial and other preconditions and by offering everyone the opportunity to secure an existence for themselves and their families. Serbia has sufficient human, financial and natural resources to eliminate - in a relatively short period of time and relying on its own strengths with the assistance of the international community - the most acute forms of poverty, particularly present in underdeveloped regions and concentrated among the most vulnerable groups.

Poverty in Serbia, apart from having similarities with other countries in transition and developing countries, also has many specific features:

First, widespread poverty is a relatively new phenomenon, caused by the dramatic drop in GDP and the living standards of citizens in the 1990s, as a consequence of the former authoritarian regime, international isolation, severe economic sanctions, negative economic consequences evoked by the disintegration of the former Socialist Federal Republic of Yugoslavia, wars in the neighbouring countries, and NATO bombing.

Secondly, the latest research on the scope and causes of poverty clearly indicates that poverty in Serbia, besides being concentrated in the traditionally under-developed South and Southeast regions, due to dramatic economic and social changes in the 1990s, has spread to other regions as well. On the other hand, poverty mostly affects socially vulnerable groups (children, the elderly, persons with disabilities, refugees and internally displaced persons, Roma, the rural population and uneducated people). For that reason, the basic empirical findings that show that 10.6% of inhabitants or 800,000 individuals are poor, should serve only as a starting point for the development of the full PRSP, since only a small shift in the poverty line increases the percentage of the poor to 20% or 1,600,000 people.

Thirdly, under such highly unfavourable economic and social conditions, the new Government resolutely initiated a painful, but unavoidable process of transition towards a modern, market-oriented and open economy. The process of modernization, restructuring and privatisation of the economy as well as the rationalization of non-economic activities which is ongoing, has caused some additional social problems, through numerous redundancies and the creation of new "pockets" of poverty, which have been concealed up to now.

The characteristics and profile of poverty in Serbia point to the following three main directions in the formulation of the Poverty Reduction Strategy:

**In the first place**, a strategy of dynamic economic growth and development, with an emphasis on job creation in the private sector. The increase in economic activities and greater international competitiveness of the domestic economy will lead to an increase in GDP, the creation of new jobs, better incomes and real sources for financing social and other public needs. This is a key development direction and the priority for Serbia, and is the only way to improve the lives of citizens and at the same time eradicate poverty permanently. This implies the continuation of the policy of macro-economic stability, the creation of an environment attractive to foreign investment and the mobilization of domestic investments; accelerated restructuring and privatisation which will revitalize those state/socially-owned enterprises capable of becoming market-oriented and competitive; the creation of a business environment for the development of entrepreneurship and faster development of small and medium enterprises; development of the control functions of the state which would legalize the so-called grey economy; a resolute battle

against corruption and organized crime; and the efficient working of state institutions – legal, executive and judicial authorities.

**The second strategic direction** is the prevention of new poverty that will result from the modernization and restructuring of the economy and rationalization of the state and its basic functions. In line with the orientation towards market and other reforms, new employment opportunities need to be offered to these groups. The state with its institutions (including the National Employment Agency, the republic and regional agencies for SMEE development, and the education system) in close cooperation with municipal authorities and local communities, through its own activities and the mobilization of non-governmental organizations, and with the expected assistance of the international community, should offer retraining incentives and opportunities. Significant economic and social efforts will be required, particularly in the regions with a traditional and non-profitable economic structure. Considerable financial resources represent a necessary, but not a sufficient condition.

**The third strategic direction** implies an efficient implementation of existing programmes, as well as defining new ones and measures and activities directly targeting the poorest and the most vulnerable groups (children, the elderly, persons with disabilities, refugees and internally displaced persons, Roma, the rural population and uneducated persons), particularly in the least developed regions. The goal of these activities is to initiate a long-term process of empowering vulnerable groups to move out of poverty, through the development of new market-oriented skills, and the provision of minimum standards of living. From the aspect of the most visible poverty, this will enable not only the survival of these groups, but also their equal access to employment, health care, education and utilities, as well as protection of their basic human rights. The permanent improvement in the overall economic and social status of the most vulnerable groups will, more importantly, prevent the recurrence of poverty within the same social groups.

The PRSP will be financed from fiscal resources, budgetary savings and additional resources with the financial assistance of the international community. This will enable the indicative costs presented in the PRSP to be reflected within the Medium-Term Expenditure Framework. In this way, the fight against poverty will find its place among Government efforts and in the preparation of annual budgets. This will enable the setting of realistic fiscal targets within financial and other constraints, and the commitment towards maintaining macro-economic stability in the country. At the same time, the “resource gap” (missing funds) will be identified, in order to define alternative scenarios for poverty reduction and the prevention of basic forms of poverty depending on the extent of support offered by the international community.

The PRSP consultative and participative process, and its adoption and implementation, are characterized by an integrated approach, aimed at:

- National ownership of the PRSP;

Inclusion of all relevant stakeholders in the implementation of the PRSP;

- Efficient and transparent information dissemination;
- Efficient monitoring of the PRSP as a whole and in its individual aspects by means of adequate and internationally comparable indicators.

This multi-dimensional approach to the alleviation of poverty, apart from significant financial resources, requires great organizational efforts, coordination between the Republic and local levels, the definition of sectoral and other priorities, strong cooperation between state institutions, civil society and the international community, professional support, and above all, a sincere willingness and readiness of all participants to participate actively and responsibly in the entire process.

## **I SCOPE AND CAUSES OF POVERTY IN SERBIA**

### **1. Main Causes of Poverty in Serbia**

In the past decade (1990-2000), the fall in the living standards of the population and the increase of poverty in Serbia resulted in the first place from a great fall in economic activity. Gross Domestic Product (GDP) in 2000, both overall and per capita, was less than half the level achieved at the end of the 1980s. Such a fall in economic activity was a consequence of a ten-year general political and economic crisis.

The main non-economic factors in this crisis were the break-up of the former Yugoslavia, wars in the region, the international isolation of the country, and NATO bombing. The main internal crisis factors originated from the interruption of the process of social and economic transformation as a consequence of reviving traditional forms of social integration and the degradation of political culture with the crumbling of socialism. All this caused a lack of political will to carry out radical institutional reforms and, consequently, slowed down the development of market institutions and of a state based on the rule of law.

The secession of the former Yugoslav Republics led to the dissolution of the FRY single market and a drastic fall in the inter-republic and foreign trade of FRY (inter-republic trade between FRY and former Yugoslav republics accounted for 40% of GDP, while trade with other countries accounted for 20% of GDP<sup>32</sup>). In addition, a considerable proportion of the infrastructure and production capacities were destroyed by NATO bombing in 1999, which had an additional unfavourable impact in terms of a fall in production and employment. Poor economic results in this period were additionally aggravated by the inappropriate economic policy which caused high inflation rates in certain years of the previous decade and the so far unprecedented hyperinflation in 1993. The hyperinflation for its part led to great impoverishment of the population and the expansion of the grey economy which became the main means of survival for the majority of the population. The difficult economic and social situation was additionally aggravated by the great influx of refugees and internally displaced persons, whose number in some years reached 10% of Serbia's population. Apart from this, the living standards of part of the population were also affected by the (temporary) inability to dispose of their income and property in the former Yugoslav republics. The number of citizens with greater social needs grew, while the economic capacity of the state to meet these needs was in constant decline, so some of the most vulnerable groups had great difficulty coping with the consequences of the economic crisis.

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<sup>32</sup> This points to the great significance of the ending of the international blockade and the establishment of normal economic relations with the former Yugoslav republics

The most important factor in the growth of poverty was the fall in per capita income since inequality in income distribution was relatively stable during the previous decade. During this period, official unemployment increased. There was also hidden unemployment since the number of the employed decreased more slowly than the sharp fall in economic activity. At the end of the period, hidden unemployment reached the level of about one third of total employment. This situation in the labour market caused a fall in real incomes and arrears in their payment generating poverty for the majority of the population.

In the period 2000-2002, the establishment of macro-economic stability and the real increase of GDP (around 4-5% annually), as well as the increase in wages and other income in real terms, caused growth in consumption and living standards.<sup>33</sup> In spite of the elimination of price disparities in 2001 and 2002, prices remained relatively stable, living standards increased in real terms and poverty was reduced. Despite the falling trend, the level of poverty is still relatively high, with the percentage of the population near the poverty line being particularly critical.

The picture of poverty is additionally burdened with 480,000 refugees and internally displaced persons.<sup>34</sup>

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<sup>33</sup> These positive results were achieved owing to the adequate external assistance and realization of the succession and privatisation proceeds

<sup>34</sup> According to the latest data of UNHCR and the Refugees Commissariat of the Republic of Serbia, 280,000 refugees and 200,000 internally displaced persons were registered in the territory of Serbia and Montenegro.

**Causes of Poverty**  
- Historical Outline -

Folk tradition very clearly distinguishes the causes of the emergence of poverty, and treats them differently. These causes can be classified into several main groups: 1. fateful, 2. inherited, 3. personal and 4. general.

Fateful poverty is the consequence of "force majeure" and it is very difficult or impossible to eliminate. Whatever one did, worked hard, created things, the result would always be negative. Something will always happen that will devalue one's efforts and leave the individual who had put his efforts into it without the rewards merited.

"Force majeure" that prevents one from getting away from poverty is called **Misery**. In the Slavic folk tradition it is represented as a supernatural being who travels around the world, attacking and torturing people. It is possible to eliminate this kind of poverty, "to take misery off one's back", as the saying goes, only if one's own or one's ancestors' sins are tracked down and atoned for.

Inherited poverty is frequent, and folk tradition is full of data and stories about poor families. This kind of poverty was very much present among the Serbs and one can freely say that it can be applied to the majority of poor people in Serbia. However, the fact is that this poor stratum has decreased over time. "Escape from this kind of poverty" has always met understanding both from individuals and from the broader community. The "escape" was fully divergent, i.e. it developed in different directions. One could change residence, find a job, become educated, save, work hard or move to a richer environment. According to folk stories collected and published by Vuk Karadžić, one could run away from inherited poverty by working, getting educated, and acquiring knowledge and awareness.

Personal causes of poverty are numerous and very clearly classified in folk tradition. Idleness, irresponsibility, laziness, prodigality, alcoholism, and gambling are the main causes of one's poverty. There is no understanding for such poverty and the common belief is that those individuals should not be given any material assistance because it is a futile effort. They are believed to be guilty for their own condition; therefore they have to find a way out by themselves. Miloš Obrenović had a similar opinion, and he did not consider poor "a good-for-nothing, a lazybones, a drunkard and the like, whom I never forgave and who are not to be forgiven for anything."

General reasons for poverty are consequences of natural disasters, economic crises or political events (wars, loss of privileges and position, state robbery). They are usually temporary and related to persons affected by some of these events. For those who become impoverished under such circumstances, if they have no personal guilt, there is great understanding among people, because they are "guilty without guiltiness" and the common opinion is that they should be given necessary assistance by the broader community and the state. They do not lose their reputation and the common belief is that they should be helped as soon as possible; also, that they will soon recover.

In the 19<sup>th</sup> century, and in some places even later, there was an institution called the "village basket" in which everyone allocated certain amounts of wheat after harvest, according to their ability and yield. That wheat would be given to the poor to feed themselves during winter and spring or when crops failed. The village chieftain would decide with the most distinguished heads of households who would have the right to use the wheat.

In former times the state was usually not blamed for poverty, and it was not responsible for fighting poverty. The common belief was that it depended on the person himself whether he would be a poor or a rich man and that his success in life basically depended on his own efforts. Thus Čedomilj Mijatović advised the young that they would best succeed in life if they stuck to traditional virtues, such as honesty, diligence and thrift (1892).

## 2. Scope of Poverty in Serbia

### 2.1. Definition of Poverty and Basic Poverty Indicators

In this section, poverty in Serbia is analysed on the basis of the Survey on the Living Standard of the Population (SLSP) that was carried out in May – June 2002 on the territory of Serbia (without Kosovo and Metohija). The main sample comprised 6,386 households or 19,725 persons. This is the largest and the most comprehensive survey on living standards carried out up to now in Serbia.<sup>35</sup> In this section poverty is primarily observed as insufficient consumption, while other sections look at the multi-dimensional phenomenon of poverty relying on all available empirical and qualitative analyses.

In 2002, poverty in Serbia was for the first time defined by using household consumption as the main aggregate in poverty measurement.<sup>36</sup>

The poverty line was defined in two steps. In the first step the food poverty line was defined as the line of absolute poverty on the basis of a minimum consumer food basket and the minimum average daily calorie intake. This was based on the consumption structure from the Survey on the Living Standard of the Population (SLSP) and adjusted to the nutritional recommendations of the FAO (Food and Agriculture Organization), a daily average of 2,288 calories.<sup>37</sup> The minimum consumer basket for a four-member<sup>38</sup> household, defined according to regular standards, amounted to 7,605 dinars a month. The second step defined the complete poverty line that, as well as expenditures on food, included also expenditures on other things (clothes and shoes, hygiene and household goods, transportation, health, and education). It was defined as the total consumption of those households whose food consumption equals the minimum consumer basket. In that way the poverty line of 4,489 dinars by consumer unit was defined. Consumer unit allows for the differences in consumption of adults and children as well as for shared household costs.<sup>39</sup> Thus every individual whose monthly consumption by consumer unit is below

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<sup>35</sup> The survey sample comprises population with permanent residence in Serbia, so that refugees and internally displaced persons are only partly included in this research.

<sup>36</sup> Just for the purposes of general comparison of the 2002 survey with previous research into poverty in Yugoslavia/Serbia, poverty was defined on the basis of household income so as to enable the use of the same aggregate for poverty measurement as used in previous research.

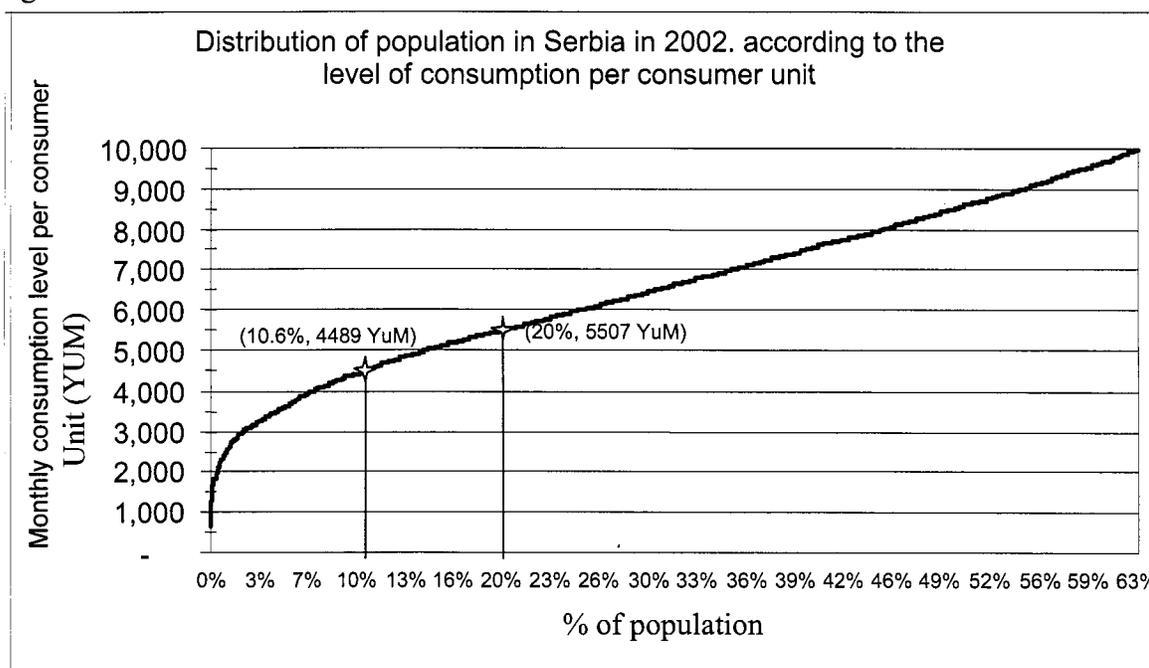
<sup>37</sup> This consumer basket reflects the current structure of consumption in Serbia. The consumer basket structure by each article equals or exceeds the consumption of the lowest decile.

<sup>38</sup> Four-member household includes two adults, one child younger than 7, and one child between 7 and 18 years of age.

<sup>39</sup> Consumer units in this study are determined empirically on the basis of SLSP data, using Engel's method. The equivalency scale used for expressing consumption of

(continued)

4,489 dinars is considered poor. About 10.6% of the population of Serbia or 800,000 individuals were below this poverty line in 2002, because their consumption by consumer unit was on average less than 4,489 dinars or 72 USD<sup>40</sup> a month, i.e. 2.4 USD a day (Table 1). The SLSP analyses show that the depth and severity of poverty are not high and that is consistent with the fact that inequality in income distribution in Serbia is not high<sup>41</sup>.



However, the concentration of population around the poverty line is high. Just a small shift of the poverty line upwards significantly increases the percentage of the poor. Consequently, the population group situated just above the poverty line is at risk of poverty, under the influence of external shocks, such as macroeconomic instability, job losses as a result of transitional economic reforms, etc. Because of that, the population situated just above the poverty line was also analysed since a small fall in real earnings

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household in terms of consumption by consumer unit is as follows: Serbian scale =  $(1 + 0.81 * (\text{Adults}-1) + 0.24 * \text{Children}(0-6) + 0.75 * \text{Children}(7-18))$ .

<sup>40</sup> The official Dinar-US dollar exchange rate was used.

<sup>41</sup> The poverty depth (gap) equalled 2.2%, which indicates the amount of resources (as a percentage of the poverty line) that the state theoretically needed to mobilize to bring the whole population above the poverty line and eliminate poverty. The severity of poverty, an indicator that takes into account that some people slide deeper into poverty, i.e. further than others below the poverty line (which gives them greater weight), reached 0.8%. The severity of poverty indicates the degree of inequality among the poor and basically depends on a comparison between groups and with the overall population (e.g. Table 1, the rural population has considerably greater severity of poverty of 1.1% compared to 0.5% for urban poverty)

and other revenues or the growth of real unemployment, could significantly increase the share of the poor in the coming period. For that reason, it is considered that the 20% of the population with consumption on average less than 5,507 dinars a month, is at risk of falling below the poverty line.<sup>42</sup>

**Table 1. Poverty Indicators in Serbia in 2002**

	Population at risk of falling below the poverty line (poverty line = 5,507 din.)			The poor (poverty line = 4,489 din.)		
	Poverty Index	Poverty gap (depth)	Poverty Severity	Poverty Index	Poverty Gap	Poverty Severity
Urban	16.0%	3.3%	1.1%	7.8%	1.5%	0.5%
Rural	25.1%	6.1%	2.3%	14.2%	3.2%	1.1%
<b>Total</b>	<b>20.0%</b>	<b>4.6%</b>	<b>1.6%</b>	<b>10.6%</b>	<b>2.2%</b>	<b>0.8%</b>

Source: SLSP 2002.

The SLSP shows that in 2002, about 800,000 people in Serbia were poor and about 1.6 million were at risk of falling below the poverty line. Observed by households, 10.3% or about 250,000 households in Serbia lived in poverty, and 19.5% or about 474,000 households were at risk of falling below the poverty line.

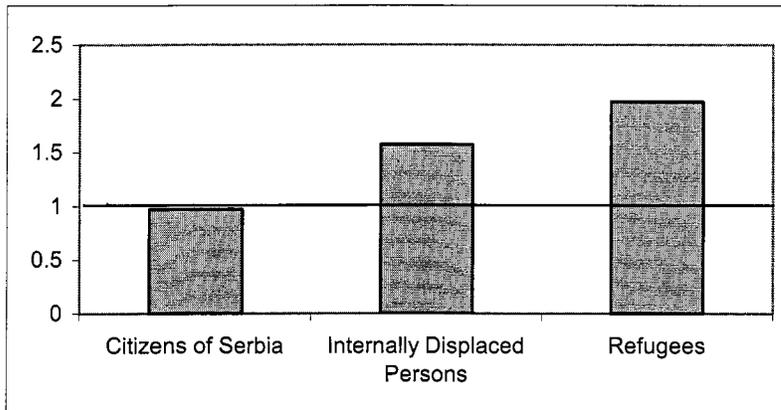
The picture of poverty in Serbia is even more sombre than this suggests, since the data discussed do not include all the refugees and internally displaced persons who are more affected and vulnerable than those with permanent residence in Serbia. Figure 1 illustrates this, showing clearly that refugees and internally displaced persons who are included in the SLSP are at much greater risk of poverty<sup>43</sup> than Serbian citizens. It is also necessary to mention that this survey does not include either Roma or the 25,000 people living in collective centres, who certainly belong to the most vulnerable group.

Arising from all these aspects, a rough estimate indicates that around a million people in Serbia are below the poverty line and more than two million are at risk.

<sup>42</sup> If a subjective measure of poverty is used, based on the understanding of an individual about the level of income necessary for meeting his/her basic needs, more than half the population in Serbia were poor.

<sup>43</sup> Relative poverty risk is calculated as the growth (fall), expressed as a percentage, of the poverty index of the reference group compared to the average poverty index.

**Figure 1. - Relative Poverty Risk of Refugees and Internally Displaced Persons in Serbia in 2002.**



Source: SLSP 2002.

**Poverty in Serbia has become a rural phenomenon**, as in the majority of other transition countries.<sup>44</sup> This can be explained by the fact that the growth of employees' earning and pensions in real terms, which represent a dominant source of income of the population in the urban areas, was relatively higher than the growth of other income sources. The other causal factor concerns difficulties in trying to encourage modern institutional practices in areas with a prevalence of traditional cultural patterns. The rural population was significantly poorer than the urban population since the poverty index of the rural population was almost twice as high as the poverty index of the urban population, while their relative poverty risk was about one third higher than the average of the total population. The depth (gap) and severity of poverty in rural areas was also higher than in urban areas. If the population at risk of falling below the poverty line is observed, it can be noted that the difference between the urban and rural population and the depth of their poverty are smaller.

## 2.2. Poverty Trends

**Comparison of the level of poverty in 2002 with previous years.** In order to form an adequate picture of the trend of poverty over a longer period, poverty in 2002 was measured in relation to income, since poverty surveys from 1995 to 2000 were also based on household income due to a lack of adequate information on consumption. For the sake of comparability, household income was defined in the same manner as previously. For the same reason the poverty line was established on the basis of the FBS consumer basket, as in former studies on poverty. The line was set at 3,560 dinars per consumer unit. HBS (Household Budget Survey) consumer units were applied to SLSP data. In this way, all three elements needed for the poverty trend analysis were made comparable. This

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<sup>44</sup> In the majority of transition countries, the reduction of urban poverty was much more successful than reduction of rural poverty.

did not, however, eliminate differences inherent in the data sources themselves (SLSP and HBS), namely, the differences in the sample and the questionnaire.<sup>45</sup> This is why a comparison of poverty in 2002 with previous years can only be used as an indication of possible tendencies.

**Table 2. Changes in poverty levels in relation to income in the period 1995-2002**

	1995	2000	2002
Poverty income in %	28.9	36.5	14.5
Poverty depth in % of GDP	4.1	3.1	3.5
Average income deficit in % of the poverty line	23.2	25.4	32.2

**Note:** The revenues of the population are defined in a comparable way for the observed period and expressed in terms of consumer units from the Household Budget Survey (HBS). The Consumer Basket defined by the Federal Bureau of Statistics was used as the poverty line for the whole period observed (1995-2002).

The data for 1995 refer to the Federal Republic of Yugoslavia according to: Posarac, S.: Human Development Report Yugoslavia (1997), while for the period 2000-2002, they refer to Serbia without Kosovo and Metohija.

**Source:** HBS for the period 1995-2000, SLSP for 2002.

Despite these methodological limitations, there are certain indications that poverty in Serbia has been reduced, since 14.5% of the population was poor according to their incomes in 2002, compared to more than a third of the population in 2000 (Table 2). The real growth in GDP, wages, pensions and other income has stimulated the growth of household income (and consumption) and a decrease in poverty. However, although the share of the poor in the total population has fallen, they need much more income to reach the poverty line. That means that the poor were much poorer on average than two years previously, and poorer than in 1995.

<sup>45</sup> For further comparability of HBS and SLSP see in Krstic (2003), The Poverty Profile in Serbia, Poverty in Serbia in 2002, Ministry of Social Affairs

### ***Who is Poor?***

#### ***- Historical Outline-***

*Classical poverty when one starves to death because one literally has nothing to eat or when an individual is not capable of providing for mere existence was very, very rare in the country of Serbia. Serbia was never a country in which people died from hunger; it has rather been a "paradise for a poor man" (Herbert Vivian, 1897).*

*There are many documents, starting from the Old Testament, that speak about poverty, the poor and their protection, but there are usually no concrete data on who is considered to be poor, where the line that divides the poor from others is and what it consists of. However, in the Byzantine document Prochiron (reference law), published in Constantinople in the 9<sup>th</sup> century, it is stated who is considered to be poor and thus not eligible to be a witness: "a poor man does not give testimony, and poor is the one who does not have property of fifty small coins." This is one of the first documents that define the poverty line by monetary value.*

*At a later date, it was again property that served as a line that reflected poverty status. Thus Prince Miloš Obrenović, asking in 1837 that taxes "should not be difficult for the poor", considered poor the one "who is really poor, who is honourable and diligent but has no land, the one who has children or is made poor in some other honourable way." He freed from direct taxes poor people with small children, who had no land but had to feed their families by working as day labourers. So, not having land was for Miloš the necessary but not sufficient condition to consider someone to be poor; the additional condition was that he/she had small children.*

*From the above examples it can be seen that the line dividing the poor and non-poor was defined by having or not having land or property.*

### **2.3. Regional Component of Poverty**

**The region with the largest share of the poor is Southeast Serbia, particularly in its rural areas.** Rural areas of Southeast Serbia are twice as vulnerable to the risk of poverty compared to the average of the entire population, while the population of urban areas is in a much better position since their poverty risk is almost at the average level. Not only is the rural population of Southeast Serbia the poorest, but also poverty in that region is the deepest and most severe. Western Serbia is the next region with an above average poverty risk, particularly the rural areas in which the poverty risk is higher than the population average by more than a third (+35.8%). The depth and severity of poverty in the rural parts of Western Serbia are also greater than the average. The data lead to the conclusion that the population of the rural areas of Southeast and Western Serbia are the most vulnerable. It represents 14% of the entire population and one quarter of the total number of the poor. One of the reasons for such an unfavourable picture in these two rural areas of Serbia should certainly be sought, among other things, in the much larger share of elderly, one-person and two-member households that were significantly poorer than other households. When the category of the vulnerable is considered, a very similar picture of regional distribution of poverty is obtained.

## 2.4. The Most Vulnerable Categories of the Population

**Gender aspects of poverty.** Poverty was approximately equally distributed between men and women since the percentage of poor men and women is almost identical (see Annex). Accordingly, the structure of the entire population by gender represents at the same time the gender structure of the poor population. The situation is the same among the vulnerable. This means that economic discrimination against women (see Anex, Table A1) was not manifested among the poorest population (the average consumption of women below the poverty line was the same as the average consumption of men). However, a number of other indicators (see Annex ) point to the unfavourable economic and overall position of women.

**Observed by age, the elderly (65+) were the poorest.** Their poverty risk was 40% higher than the population average, and the depth of their poverty was also much greater than the average (Annex). They represented 17.7% of the total population and almost a quarter of the total number of the poor. Pensioners made up the largest share in the category of old persons (69%), particularly in urban areas, while other groups had smaller shares: supported persons (22%), agricultural workers (7%) and others (2%).

In considering poverty among pensioners, it is noteworthy that agricultural pensioners, particularly in rural areas, were much more affected than other pensioners, having a poverty risk twice as high as the general population average and facing significantly deeper and more severe poverty compared to other pensioners. Their situation worsens the overall picture of poverty among pensioners since their pensions are extremely low and were very much in arrears.

**Children and poverty.** The next category with an above average poverty risk is that of children. 12.7% of the population in this age group were poor, and their relative poverty risk was 20% higher than the population average. However, the share of children of this age group in the poor population is much lower than the share of the elderly, reaching 10.3%. Although children do not represent a significant proportion of the poor (because of their low share in the total population), their poverty was relatively deep in comparison to other age groups. The distribution of the share of the population at risk of falling below the poverty line in the total population according to age does not differ from the age distribution of the poverty index.

**Poverty was more present in households without children than in households with children (Annex).**<sup>46</sup> The poverty risk in households without children was above average (+8.5%), and they made up more than two thirds of the poor. The depth and severity of their poverty was close to the average. Observed according to the household size, the most affected were households of five and more members (poverty risk of +26.3%), while

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<sup>46</sup> The Roma population was not included.

observed according to household composition, poverty was most present among single-person and two-member elderly households.

The most affected were elderly two-member households since their poverty risk was almost two thirds higher than the general population average.<sup>47</sup> They made up 12.2% of the total number of poor households, and the depth and severity of their poverty was much greater than the average.

Finally, it is necessary to point out that the categories of households that were most exposed to poverty correspond to those whose economic and material situation was the worst (population at risk of falling below the poverty line).

**Link between educational level and poverty.** It is easy to draw the conclusion that the share of the poor falls with the rise in educational level. People who are at greatest risk of poverty are primary school dropouts. The poverty risk in the case of these people was twice as high as the general population average and the depth and severity of poverty was significantly greater than in the case of people with higher educational levels.

Highly educated persons (college and university level) were not subject to the risk of poverty as their poverty risk was below average. Only 2.9% of college graduates and 2% of those with a university degree were poor. Such a distribution of poverty related to education level demonstrates that education pays off, since it is rewarded by the labour market. A very similar picture can be seen when the category of the vulnerable are observed by educational level.

Table A3 in the Annex shows poverty by social and economic status according to self-declaration. The poverty indicators differ significantly according to socio-economic status and the type of settlement.

**Among participants appearing in the formal labour market, the unemployed were at greatest risk of poverty (59.4% higher than the population average), and also of the deepest and most severe poverty. Individuals employed in the formal labour market had a below-average risk of poverty.** When observed according to type of settlement, the unemployed in the rural areas were the most vulnerable, since their poverty risk was twice as high as the general population average or 39.4% higher than the average of the rural population. In contrast, those formally employed in urban areas whose poverty index was more than two times lower than the population average and 38.6% lower than the average of the urban population were in the most favourable economic position.

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<sup>47</sup> Elderly households are defined as households whose members are all 65 years of age and older

On the basis of these results, we can conclude that the categories of population in Serbia who are at greatest risk of poverty are:

1. **The uneducated;**
2. **Unemployed and supported persons;**
3. **Elderly people (65+) and children;**
4. **Households with five and more members;**
5. **Elderly single-person and two-member households, particularly in rural areas;**
6. **Agricultural pensioners, particularly in rural areas;**
7. **The population of rural areas of Southeast and Western Serbia;**
8. **In addition, various research and other analyses show that Roma, internally displaced persons and refugees, as well as persons with disabilities, belong to the vulnerable groups exposed to the highest poverty risk.**

## 2.5. Income/Consumption Inequality

### 2.5.1. Basic Income/Consumption Inequality Indicators in Serbia in 2002

Basic income and consumption inequality indicators are shown in Table 3. The Gini coefficient, based on per capita consumption and on the consumer unit, reached the value of 30, while it was somewhat higher when calculated for income.<sup>48</sup> The Decile Relationship shows that the consumption by consumer unit of the poorest person in the last decile was 6.7 times higher than that of the richest person in the first decile.

**Table 3. Basic Inequality Indicators in Serbia in 2002.**

	Gini Coefficient			Decile Relationship		
	Per capita	By Consumer Unit	Consumer	Per capita	By Consumer Unit	Consumer
<b>Consumption</b>	30.0	29.7		6.8	6.7	
<b>Income</b>	33.3	32.2		9.8	8.1	

Source: Branko Milanovic, Poverty in Serbia in 2002, Ministry of Social Affairs.

**Table 4. Income Inequality in Serbia in the period 2000 - 2002.**

	Gini Coefficient	
	Per capita	By Consumer Unit
<b>2000</b>	28.3	28.4
<b>2002</b>	34.4	33.9

Source: HBS 2000 and SLSP 2002.

<sup>48</sup> The Decile Relationship is defined as the relationship between the consumption (income) of the 90<sup>th</sup> percentage and 10<sup>th</sup> percentage. For this reason, the decile relationship is sensitive only to the changes at the ends of distribution, unlike the Gini coefficient which measures inequality over the whole consumption (income) distribution.

Income inequality in 2002, measured by the Gini coefficient, increased compared with the two previous years (Table 4) by about 6 Gini points (both per capita and by the consumer unit).<sup>49</sup>

Income inequality in Serbia corresponds approximately to the average value of the Gini coefficient for the group of selected transition countries (Table 5). In comparison with the countries of the former Yugoslavia, income inequality in Serbia is between the levels in Bosnia and Herzegovina, Macedonia and Slovenia, on the one hand, and Croatia, on the other. The value of the Gini coefficient in Serbia, equalling 33, is situated within the value span of these countries which range between 26 and 36.

**Table 5 Comparison between inequality of incomes in Serbia and selected East European countries (countries are ranked according to the Gini coefficient, on per capita basis)**

Country (year)	Income or expenditures per capita (USD)	Gini coefficient
Hungary (income; 1999)	1800	26
Slovenia (income; 1998)	4900	26
Bosnia (income; 2001)	1300	27
Macedonia (1998)	1000	29
Byelorussia (expenditures; 1999)	630	30
Ukraine (income; 1999)	820	30
Bulgaria (income; 1999)	820	33
Lithuania (expenditures; 2000)	1200	33
<b>Serbia (income; 2002)</b>	<b>1480</b>	<b>33</b>
Croatia (expenditures; 1998)	3200	36
Estonia (income; 2001)	1600	38
Russia (income; 2000)	1000	40
<i>Unweighted average</i>	<i>1360</i>	<i>32</i>

**Note:** For Bosnia, Croatia and Byelorussia - incomes without imputed rent.

**Source:** Branko Milanović, Poverty in Serbia in 2002, Ministry of Social Affairs.

In comparison with other countries in transition, inequality in Serbia is somewhere between the values recorded in the Central European countries that have an inequality level below 30, and the Republics of the former Soviet Union (Estonia and Russia - close to 40).

<sup>49</sup> Household income, for the purposes of this comparison, has been defined in the same way as in 2000, so income Gini coefficients in this and in the previous table differ. This means that household income does not include either income from durable consumables, or imputed rental value (for more details about other income components, see the discussion on inequality breakdown).

### **2.5.2. Breakdown of Income/Consumption Inequalities**

Labour earnings are the most important source of total income (45.5%) and represent the largest share in total income inequality (47% or 15 Gini points<sup>50</sup>). After labour earnings, a smaller share in total income is attributable to pensions (16.3%), natural consumption (12.8%) and incomes originating from agricultural property (11.4%). Pensions and natural consumption are characterized by lower inequality than total income, and their share in total inequality amounts to 12.7% and 11% respectively or 5.3 and 3.5 Gini points. Income from agriculture has a relatively high concentration index (46.1), so that it accounts for 16.5% of total inequality. Other income sources contribute to a far lesser extent to total inequality.

### **2.6. Transfers necessary for raising the consumption level of the poor**

Under the assumption of perfect targeting, and of the Government opting for the provision of (passive) social assistance to the poor as the only measure, it would have been necessary to provide 9.1 billion dinars (Table 6) or 1% of GDP<sup>51</sup> (not including administrative costs of payment of assistance) in order to eradicate poverty in Serbia in 2002. This is in addition to the amount of assistance already provided to the poor through material support to families (MOP). Since the assumption of perfect targeting is unrealistic, the actual funds necessary for the elimination of poverty might be several times higher than this minimum amount. If the targeting of social assistance to the poor were 70%-60%, it would be necessary to provide between 11.8 and 12.7 billion dinars for the elimination of basic poverty.<sup>52</sup>

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<sup>50</sup> The Gini coefficient corresponds to the sum of weighted average concentration indexes for each income source, whereby the weights represent the shares of corresponding income sources in the total income. The concentration index is calculated in the same way as the Gini coefficient, but the difference consists in the fact that it represents the distribution of a certain income source when the households (individuals) are ranged according to total income, and not according to the income source. (In the case of the Gini coefficient, the ranging criterion is a variable for which Gini – total income is being calculated.)

<sup>51</sup> GDP for the year 2002, which amounted to 948.3 billion dinars, was used for these calculations. The total population of Serbia was 7.45 million.

<sup>52</sup> In market economies, these resources are at least twice as high as the minimum amount necessary for the eradication of poverty in the case of perfect targeting. In transition countries, (Poland, Hungary, Bulgaria, Estonia and Russia) for 1 US dollar of assistance to the poor, between 1.5 and 8 US dollars were actually spent, not including the administrative expenditures related to the payment of these amounts (Braithwaite, J. Grootaert, C. and Milanovic, B. 1999, Poverty and Social Assistance in Transition Countries).

**Table 6. Passive transfers necessary for raising the consumption of the poor population to the poverty line level**

	<b>2002.</b>
Average spending of the poor	3,539
Poverty line	4,489
Average resource gap	950
Average deficit (in % from poverty line)	21,2%
<b>Budget necessary for eradication poverty</b>	
Perfect targeting, in billion dinars	9.1
70% -60% targeting, in billion dinars	11.8-12.7

Source: SLSP 2002.

However, a permanent solution to the problem of poverty in Serbia, as defined by the PRSP, requires an active and multi-dimensional response to this challenge, not a passive one.

It follows that the calculation of the minimum financial resources necessary for the elimination of basic poverty must include a wider range of measures including health care and educational measures, incentives for raising income and the employment rate, the creation of a favourable environment for entrepreneurship and private sector development, and proactive social support and social inclusion of vulnerable groups.

### 3. The influence of economic growth on poverty reduction

The projections of the poverty trend until the year 2010 are based on the assumption that inequality between spending and GDP growth in real terms of 5% per year will remain unchanged.<sup>53</sup> During the period, personal consumption, which is directly linked to the dynamics of poverty, would rise on average 1.9% a year in real terms (see section 1.3.1 on macroeconomic projections). During the first sub-period (2003 – 2006) real growth of personal consumption would be somewhat slower (1.4%) compared to the second sub-period (2.3% from 2007 to 2010). Such growth of personal consumption by 2006, with no change in inequality, would reduce the poverty rate by 20%, while the percentage of the vulnerable would drop by 18% (Table 7). The fall in the poverty rate would be accompanied by an improvement in the depth of poverty. A rapid rise in personal consumption in the second sub-period would accelerate poverty reduction. Thus the percentage of the poor and the population at risk of falling below the poverty line in 2010 would be almost halved compared to 2002, under the assumption of unchanged inequality.

**Table 7. Projections of poverty in Serbia 2003-2010**

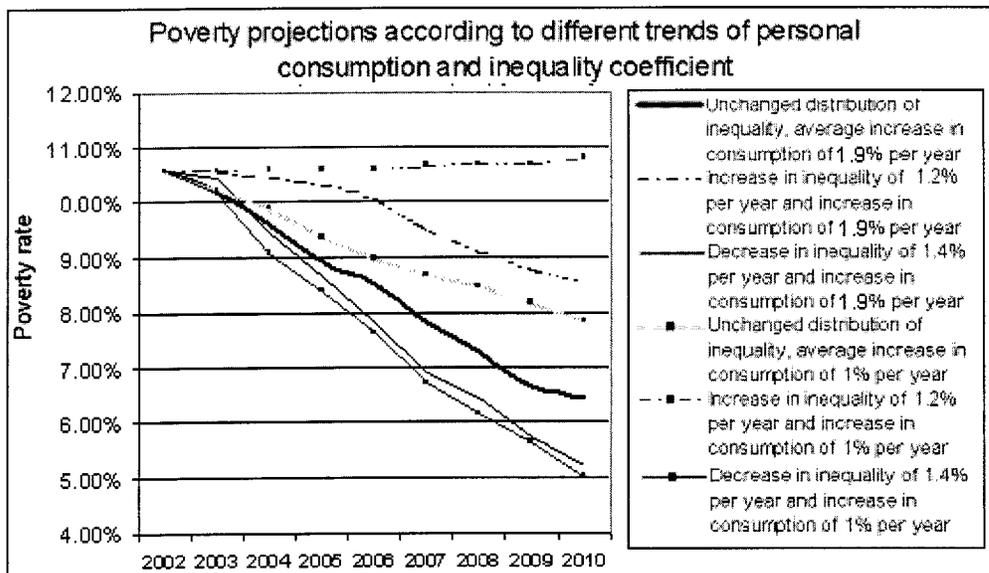
	Population at risk of falling below the poverty line		The poor	
	Poverty index	Depth of Poverty	Poverty index	Depth of Poverty
<b>2002</b>	20.0%	4.6%	10.6%	2.2%
Personal consumption rises on average 1.7% a year (2003 – 2006)				
<b>2006</b>	16.5%	3.8%	8.5%	1.8%
Personal consumption rises on average 2.3% a year (2007 – 2010)				
<b>2010</b>	12.6%	2.8%	6.5%	1.3%

**Note:** Consumption inequality remains unchanged.

**Source:** SLSP 2002

The graph below shows the possibility of a considerable decrease in poverty (from 10.6% in 2002 to 6.5% in 2010) with the assumption of an average annual growth in GDP of 4.5% and the growth of personal consumption of 1.9% a year, as well as the set of scenarios for the less ambitious growth of personal consumption of 1% a year.

<sup>53</sup> The poverty line remains unchanged.



The graph displays three basic scenarios of inequality of consumption and two scenarios of growth of personal consumption (1% and 1.9% a year). The first scenario of inequality exhibits no changes in the Gini coefficient of inequality (at the level of 0.31) in the period observed. The second predicts a moderate rise in the Gini coefficient to 0.34 in 2010; at 1.9% annual growth in personal consumption the level of poverty is 8.6%. The third predicts a drop in the coefficient to 0.28 in 2010; at 1.9% annual growth in personal consumption the level of poverty is 5.2%. The second set of scenarios predicts a less optimistic rise in personal consumption – at zero change in inequality the poverty rate in 2010 is 7.8%; at a rise in inequality of 1.2% a year, the rate is 10.8% and if inequality falls by 1.4% a year the poverty rate in 2010 will be 6.5%.

The assumption of unchanged inequality means that the poor benefit from economic growth in the same way as the average population. If the inequality in consumption dropped in the period observed, at the same rate of average growth of personal consumption of 1.9% a year, the alleviation of poverty would exceed that exhibited in Table 7. This means that the poor would benefit more from economic growth than the average population. On the other hand, a rise in inequality with the same rate of consumption growth would lead to a rise in poverty in Serbia.

## II TRANSITION AND REFORM FRAMEWORK FOR POVERTY REDUCTION

### 1. Macroeconomic Framework and Factors of Sustainable Economic Growth

Although a multidimensional definition of poverty has been used, the level of consumption is still a critical factor for determining the poor and the vulnerable. Because of this, increased consumption by the poor will reduce poverty, but also positively influence economic growth.

Because total national consumption is an important element of total production (GDP), consumption by the poor will probably increase with the growth of production as long as inequality in society does not increase, and the foreign, domestic and debt balances remain the same. In other words, economic growth will, under these conditions, ensure economic opportunities for the poor, in the form of employment or increased income, which will enable them to overcome poverty.

Achieving internal and foreign economic balance (getting the fiscal and balance of payments deficit under control) is not only a condition for the poor to benefit from economic growth. It is also a precondition for achieving sustainable economic growth, while a loss of control would lead to macroeconomic instability and would have a negative effect on economic growth.

#### 1.1. Macroeconomic Policy

During 2001-2002 **macroeconomic stability was established** and basic structural reforms were initiated. This is a firm base for the continuation of the reforms and establishing medium-term growth as a framework for poverty reduction. **Macroeconomic policy** was directed towards the removal of the basic misbalance and towards creating the basis for medium-term sustainable macroeconomic stability. Complete price liberalisation (except for infrastructure service prices) was introduced.

**Monetary policy** was directed towards controlling inflation which arose as a result of price liberalisation, and after that as a result of correcting price disparities and changes within the tax system. The money supply followed strong re-monetization and it was created mainly through foreign currency inflow. Only a small amount of currency emission was used to cover the fiscal deficit. The price liberalisation set foreign currency exchange rates at the market level, the flexible exchange rate was introduced, as well as convertibility on current transactions (Article VIII, IMF). By the NB policy, the nominal exchange rate was kept at a constant level during the last two and a half years, which led to considerable real appreciation of the Dinar.

One of the consequences of the real appreciation of the Dinar is that salaries have increased in Euros. On one hand, this lowered the competitiveness of the economy and on the other hand, it increased the purchasing power of the population in buying imported products. All

this obviously had an averagely good influence on the rich, but at the same time just a small effect on improvement of the status of the poor.

With the price liberalisation policy, one of the main sources of the inherited **quasi-fiscal deficit** was corrected. The prices of infrastructural services were increased, so now they mainly cover direct costs of production. The electricity price was increased four times and has reached the sum of 4 cents per kWh, which covers operating expenses. The price which will enable the Serbian power generation economy to work normally is 4.5 cents per kWh. A significant correction of the utility service price was also achieved. The correction of price disparity is a significant condition for medium-term sustainable macroeconomic stability, because it decreases public expenditures on direct and hidden subsidies. Establishing price parity of infrastructure services is significant for rational resource usage and for achieving sustainable medium-term growth. On the one hand these measures had a negative effect on the poor, but on the other hand they released budgetary resources, which enabled the government to increase the level of direct support through better targeted programmes such as social protection and pensions.

**Fiscal policy** was interwoven with fiscal reform, and their goal was to enable necessary adjustments and public revenue and expenditure reform, and to create the necessary institutions. The basic measures in that direction were the introduction of a single sales tax rate (20%), and so called gross salaries as a tax base. The single sales tax rate contributed to the removal of arbitrariness. Its introduction represents a good base for the planned introduction of value added tax in 2004.

During 2002-2003, because of the negative effects of these measures on the poor, the Government annulled sales tax on some of the most important food articles and communal services.

Gross salaries now include the total income of employees (lunch, vacation bonus, etc.) as a base to determine taxation and incomes, so the actual labour costs were stated, and labour taxes according to sectors were balanced. In the medium term, this measure should lead to better labour allocation and to the restructuring of inefficient sectors, which should encourage sustainable growth. In the short term, it had a negative effect on employees in non-productive sectors (textile etc.), because most of their low salaries were gained through items which were not previously included in the tax base

The basic changes in public expenditures were directed towards better management of expenditures (introduction of the non-budget items into the budget, explicit budgeting of subsidies, defining fund deficits and providing budgetary transfers to cover them, etc.), providing regular payments (including pensions) and the reduction of payment arrears (social assistance), introducing the transition fund to support the people most affected by the reforms, larger increases in salaries in the education and health sectors compared to the public sector in general, etc. Most of these measures improved the status of vulnerable groups.

## 1.2. Basic Macroeconomic Indicators

The following macroeconomic indicators should determine the relative position of Serbia regarding development and poverty, its macroeconomic performance during the first two years of stabilization and finally its initial position for future medium-term growth.

There are two basic factors which determine the level of poverty in a country: the spending p.c. (per capita) level and inequality in distribution. The spending level is closely linked to the level of the gross domestic product (GDP) p.c. defined according to purchasing power, while inequality in distribution is measured by the Gini coefficient.

Since there are no estimates of GDP by purchasing power in Serbia, GDP according to the current exchange rate will be used. See Table 1.

**Table 1**

	Serbia		Bulgaria	Romania	Croatia	Hungary
	2001	2002	2001	2001	2001	2001
<b>GDP pc in USD</b>	1409.0	1945.7	1675.0	1743.0	4385.0	5228.0
<b>Gross salaries USD</b>	143.0	217.0	106.0	143.0	535.0	360.0
<b>Net salaries USD</b>	97.6	151.0				
<b>Pensions USD</b>	81.0	108.5				
<b>Unemployment rate %*</b>	28.6	30.5	16.3	10.8	16.1	6.5
<b>Investments / GDP %</b>	10.9	13.3	20.4	21.9	23.8	27.3

\* The unemployment rate is determined according to data from the Employment Bureau.

The GDP p.c. is the same as in Romania and Bulgaria, but is less than half that in Croatia and Hungary. The next indicators of spending are average salaries and pensions: salaries are higher than in Bulgaria and Romania, probably pensions as well because they are connected to salaries.

In spite of macroeconomic stabilization and the commencement of the reforms, during the first two years of transition the Serbian economy recorded significant GDP growth (Table 2), even if the high growth of agriculture in 2001 is excluded. The transitional recession affected only industry, which after the period of inactivity in 2001, began to grow in 2002.

This suggests that transitional recession should not be expected in future reforms, and it seems that Serbia can follow the path of sustainable growth. It is obvious that the major production decrease in the 1990s and the accompanying low level of capacity usage caused the already very low level of production to fall to the minimum.

**Table 2**

in %

	Serbia	
	2001	2002
<b>Growth rates :</b>		
<b>GDP</b>	5.5	4.0
<b>GDP without agriculture</b>	2.0	5.0
<b>Industrial production</b>	0.0	1.8
<b>Average salaries</b>	16.5	29.9
<b>Inflation:</b>		
<i>Average period</i>	92.0	19.2
<i>End of the period</i>	39.0	14.8

A very high real increase of average salaries was also recorded. Part of the increase was caused by the increase in unemployment (see Table 1), which excludes people with very low salaries. In addition we must take into account the effects of the decrease in contributions on salaries of 10% which turned into a rise in net salaries. Finally, mistakes in registering salaries happen very often, taking into account that the system of salaries that did not include benefits (for public transport, lunch bonus etc) was supplanted by the system which does include them. In the light of all this, previous official data certainly overestimate the real rise in salaries. But a real salary increase does exist, which means an improved status of employees. The above-mentioned average salary increase in foreign currency, should be also included.

After the price liberalisation at the beginning of the programme, and after correcting price disparity, inflation was brought under control, so its further medium-term decrease is possible.

In 2001 and 2002 there were relatively high growth rates together with a drop in employment, which, at first sight, seems paradoxical. This is mainly due to the fact that those who lost their jobs had hardly been working at all.

In the medium term, the sustainability of stabilization that has been achieved can be valued on the analysis of internal (basically fiscal) and economic trade imbalance. The review of basic indicators is given in Table 3.

**Table 3**

	Serbia	
	2001	2002
<b>Export/GDP</b>	25.3	19.3
<b>Payment deficit/GDP</b>	-10.3	-12.0
<b>External debt/GDP</b>		66.5
<b>Public expend/GDP</b>	39.5	46.1
<b>Public income/GDP</b>	38.0	42.5
<b>Fiscal deficit/GDP</b>	-1.5	-3.6
<b>Primary deficit/GDP</b>	-0.9	-2.6
<b>Public debt/GDP</b>	...	92.2

Public revenue and expenditure represent consolidated values in the Serbian territory; this includes the Republic, Federal, and local communities' budgets and funds. In 2001, there were already plans for significant fiscal adjustments with a deficit of approximately 3.5%. The actual deficit was less than half of that (1.5%), primarily due to the postponement of expenditures related to the servicing of foreign debt and the support of reforms. The result for Serbia was an unrealistically low level of public expenditures (39.5%). The total amount of public expenditures appeared in 2002, and it increased public spending to 46.1% of GDP, which represents a large sum for an economy in transition (see Table 7).

The fiscal deficit remained fairly moderate (3.6%) and by the standards of the EBRD represents a moderate risk. On the other hand, the existence of a relatively significant primary deficit (deficit that does not include interest payments for public debt servicing) presents a risk of unsustainable increases in public debt. Therefore, the primary deficit should basically be covered by non-credit resources (privatisation, donor funds and income from issued money), in order to prevent the explosion of debt. The public debt is very large (92.5 %), and for the most part it represents foreign currency debt: old foreign currency savings and foreign debt.

**It follows that mid-term fiscal sustainability does not leave room for the increase of public spending in GDP,** and requires that fiscal deficit be financed mainly from privatisation. This would enable a decrease in public debt to a sustainable level and, along with the expected moderate fiscal deficit, lead to medium-term internal sustainability, with low inflation.

**Serbia's external economic position looks critical for the maintenance of medium-term macroeconomic stability.** The current balance of payments deficit is high for both years (see Table 3). In 2002 the deficit equalled 12% of GDP, which in the medium term would be hard to maintain and falls into the critical zone according to the basic criteria of the EBRD. The main cause of the large deficit is the very low level of exports, which is now at half the level of Serbian exports in 1990; or between one third to one half of Bulgarian or Croatian exports relatively speaking (in terms of GDP) (see Table 8).

The foreign debt in comparison to GDP is fairly high, but not critically large (the borderline is 80%). However, with a high current balance of payments deficit and its coverage with new loans, the foreign debt could become unsustainable.

**Therefore, a critical problem with medium-term macroeconomic sustainability is represented by the size of the current balance of payments deficit and its financing.** This refers to the crucial role of export growth and foreign direct investment. The large real appreciation of the Dinar and the consequently high level of labour costs expressed in foreign currency certainly do not aid exports or foreign investment.

**Finally, medium-term growth will crucially depend on the rates of investment.** Serbia achieved very low levels of investment in 2001 and 2002, almost half that of the other economies compared to (see Table 1). Therefore, to achieve the desired growth, it is

necessary to provide conditions for a significant increase in rates of investment within the Serbian economy.

### 1.3. Medium-term sustainable growth

The analysis of sustainable growth should provide a consistent macroeconomic framework for the medium term, and examine the sustainability and risk of the projected growth, and the determinants that define its size.

#### 1.3.1. Macroeconomic projections and their sustainability

##### Rise in production, investments and savings

Keeping in mind the expected rate of growth of the real GDP of 4-5%, the medium-term macroeconomic implications are now considered.

The following Table projects the trends of the nominal GDP in Serbia and its possible structure.

**Table 4. - GDP and its structure**

	2002	2003	2004	2005	2006	2007	2008	2009	2010
<b>GDP current prices, billion Dinars</b>	931.0	1.118.2	1.263.0	1.402.4	1.535.9	1.677.2	1.831.5	2.000.0	2.184.0
<b>GDP, million USD</b>	14.592.5	19.280.0	20.441.2	21.634.3	22.909.1	24.301.9	25.779.5	27.346.9	29.009.6
<b>GDP pc, USD</b>	1.945.7	2.560.4	2.703.9	2.850.4	3.006.4	3.176.7	3.356.7	3.546.9	3.748.0
<b>GDP real growth</b>	4.0	3.1	4.1	4.5	4.5	5.0	5.0	5.0	5.0
<b>Structure, in % GDP:</b>									
<b>Domestic demand</b>	123.6	120.0	119.0	118.0	116.0	114.5	114.0	113.0	112.0
<b>Spending</b>	109.6	104.3	101.8	98.0	95.0	92.5	91.0	89.0	87.0
<i>Personal spending</i>	91.0	86.3	84.6	81.5	79.0	76.5	75.0	73.0	71.5
<i>Public spending</i>	18.6	18.0	17.2	16.5	16.0	16.0	16.0	16.0	15.5
<b>Investment</b>	14.0	15.7	17.2	20.0	21.0	22.0	23.0	24.0	25.0
<b>Net export of goods and services</b>	-23.6	-20.0	-19.0	-18.0	-16.0	-14.5	-14.0	-13.0	-12.0

Total spending (domestic demand): personal, public and investment, is larger than GDP for the sum of the export and import of goods and services deficit. This spending must be decreased over a period of time so as to provide foreign economic sustainability, i.e. to decrease the balance of the goods and services deficit. The basic structural change aimed at

involves the relationship between personal spending and investment. The rate of investment should significantly increase in the medium term, from 14% to 25% of GDP, and in that way attain a level comparable to the countries in transition (see Table 1). This requires a relative decrease in personal spending (to 71%) and a decrease in material expenditures for public spending (to 15%) of three percent. Consequently, personal spending should realistically grow at an annual rate of 1.8 %, and public spending at the rate of 2.2%, which is considerably lower than GDP growth.

The relationship between the share of economic (private) and public investments in fixed capital can be appraised based on the well-known structure of investment in 2002: from a total of 14% investments in GDP, 12.1% make up fixed fund investments, and from that 10.1% are economic (private), and 2% public investments.

In view of the fact that investments are financed by domestic savings and foreign influxes, domestic savings can be estimated by taking away the current balance deficit (meaning the influx of foreign resources) from the investment.

**Table 5. – Domestic savings** %GDP

	2002	2003	2004	2005	2006	2007	2008	2009	2010
<b>Investments</b>	14.0	15.7	17.2	20.0	21.0	22.0	23.0	24.0	25.0
<b>Current balance deficit</b>	12.0	11.5	10.0	9.5	8.8	8.0	7.0	6.5	6.0
<b>Domestic savings</b>	2.0	4.2	7.2	10.5	12.2	14.0	16.0	17.5	19.0

It follows that for sustainable medium-term growth it is necessary for the Serbian economy to achieve a higher level of investment supported by a large increase in domestic savings. With regained confidence in the financial and banking sector, the transfer of domestic savings will be initiated as well as the transfer of money currently engaged in the grey economy into the formal economy. This is a precondition for achieving the projected rise in domestic savings.

#### **Mid-term Internal Balance: Fiscal Projections**

The medium-term internal balance is decisively determined by fiscal sustainability. Medium-term fiscal projections are given in Table 6.

**Table 6.**

%GDP

	2002	2003	2004	2005	2006	2007	2008	2009	2010
<b>Income, consolidated</b>	42.53	42.4	42.0	41.8	41.7	41.7	41.6	41.4	41.2
<b>Expenditures, consolidated</b>	46.07	46.1	45.6	45.2	44.8	44.3	43.9	43.5	43.1
<b>Total deficit</b>	-3.5	-3.7	-3.6	-3.4	-3.1	-2.6	-2.3	-2.1	-1.9
<b>Primary deficit</b>	-2.6	-1.9	-1.5	-1.3	-1.0	-0.6	-0.3	-0.2	-0.1
<b>Public debt</b>	92.19	80.3	76.7	69.8	65.2	60.6	55.7	51.0	47.0

The projections take into account the above-mentioned imbalance. The share of consolidated public revenues in Serbia in GDP should decrease by 1.3 percentage points, to 41.2% in 2010. Public expenditures should drop by 3% down to 43.1% of GDP at the end of the period<sup>54</sup>. Consolidated revenue and expenditures in the medium term are acceptable in relative terms.

The fiscal deficit falls from 3.7% to 2% of GDP which is modest and acceptable. The primary deficit is eliminated in the medium term, although it is not negligible until 2006. The fiscal deficit is principally financed from the privatisation income projected at 2% to 3% of GDP. Since the incomes exceed the primary deficit, the share of public debt in GDP is considerably reduced to the level of 47% at the end of the period.

A comparative survey of public revenues, expenditures and deficits, displayed in Table 7, shows that the medium-term fiscal projections discussed above are reasonable.

**Table 7.**

%GDP

	<b>Bulgaria 2001</b>	<b>Romania 2001</b>	<b>Croatia 2001</b>	<b>Hungary 1999</b>
<b>Income</b>	37.7	31.4	38.7	42.3
<b>Expenditures, consolidated</b>	40.0	36.0	49.3	45.8
<b>Total Deficit</b>	-2.3	-4.6	-10.6	-3.5

The risks involved in medium-term fiscal sustainability are primarily tied to the projected income from privatisation and its use for the coverage of the deficit. That is, in the event that the primary deficit is covered by a new debt, this would lead to a non-sustainable growth of

<sup>54</sup> There have been announcements from government representatives that public expenditures and fiscal deficits will decrease faster than was stipulated in the previous table. However, these announcements have not yet appeared in the Budget Memorandum, nor in any other government documents.

public debt. Preliminary research indicates that projected income from privatisation is achievable.

Another risk originates from the question whether or not it is possible to maintain the scope of public spending within the projected framework. Aggregate comparisons between the initial state in 2002 and the confirmed budget for 2003 on the one side, and international comparisons on the other, suggest that that is possible. However, this should be confirmed by a more detailed analysis of public expenditures in Chapter II. The projected level of public income is achievable.

### Medium-term external balance of payments equilibrium

It has already been pointed out that the basic macroeconomic imbalance in Serbia's economy represents a large deficit in the current foreign balance of payments, caused by the disproportionately low level of exports. The projections of the current deficit have previously been used for calculating the amount of domestic savings. The sustainability of the projections is now discussed.

**Table 8.** %BDP

	2002	2003	2004	2005	2006	2007	2008	2009	2010
<b>Current deficit</b>	12	11.5	10	9.5	8.8	8	7	6.5	6
<b>Financing:</b>									
<b>Foreign direct investments</b>	6.0	7.5	7.0	6.0	5.5	5.9	6.2	5.4	5.0
<b>Donations</b>	2.0	1.5	1.0	0.5	0.5	0.2	0.2	0.2	0.2
<b>Indebtedness</b>	4.5	2.5	2.0	3.0	2.8	1.9	0.6	0.9	0.8

<b>Foreign debt/GDP</b>	66.5	58.8	60.6	62.6	61.1	58.4	56.0	53.5	51.1
<b>Rate of debt servicing (servicing/export)</b>	5.5	13.1	15.0	15.9	18.0	20.9	20.1	18.7	17.6

<b>Export of goods and services (%GDP)</b>	19.3	19.5	22.5	25.5	27.8	30.0	31.7	33.4	35.0
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A very high current deficit remains until 2006, and 10% of GDP (EBRD) can be taken as a critical limit of medium-term sustainability. Apart from the extent of the deficit, the length of its sustained existence also poses a risk.

Financing the projected current deficit should show whether it is sustainable to continuously produce a high deficit in the medium term. Sustainability demands that foreign direct investment should play a key role in financing the deficit. The share of such investment in GDP should range between 5% and 7%. In absolute amounts, these investments should range between 1.3 billion to 1.6 billion USD a year.

A high share of foreign direct investment is necessary to maintain the flow of loans for financing the deficit at an acceptable level in relation to the sustainability of the foreign debt. The projected debt for financing the current deficit thus drops from 4% to 1% of GDP.

All this makes the foreign debt sustainable. That is, the share of foreign debt in GDP falls from 66% to 51% (the critical level is 80%), while the debt servicing rate amounts to 20% at most (the critical value being 25%). This, of course, is possible since two thirds of the debt was written off by the Paris Club. It is also expected that debts to the London Club, and to Russia, China and others will be successfully reprogrammed, and this was taken into account in the above assessment.

#### **1.4. Sustainability of projected economic growth: sources of growth**

The previously outlined medium-term macroeconomic projections are based on the assumption of 5% real growth. A significantly lower rate would bring high risks because some basic factors, like the servicing of foreign debt and public spending, are almost independent of the scope of production. Therefore, slower growth of production would mean proportionally larger public expenditures and a higher fiscal deficit on the one hand, and a larger rate of foreign debt servicing on the other.

The latest projections of the IMF (July, 2003) basically assume the same rate of growth as does this analysis. A growth rate of 4% in 2004 and 4.5% in 2005 is predicted. Although our projections are given for a growth rate of 5%, they would in fact be sustainable for every rate between 4% and 5%. Two other important elements of the macroeconomic framework, external sector and fiscal, are also basically consistent with these two analyses.

In the following part of the document, we shall discuss how realistic the projected growth is in the wider context of the impact of the reforms on growth, based on the accumulated experience of transitional economies, as well as the question of whether the projected macroeconomic framework can serve as a basis for the projected level of growth.

The growth survey in 13 European countries over the transition period (1989 to 2001) brings out three basic points relevant to the assessment of the medium-term growth rate in Serbia. In the first place, all the countries have gone through a sharp transitional recession with a significant fall in production. Secondly, after passing through the transitional recession, a certain number of countries were able to achieve continuous growth in production (Hungary, Poland, Slovakia, etc) while others (Bulgaria, Romania, Czech Republic, etc) have entered into yet another recession. Finally, the highest level of medium-term growth achieved is approximately 5%.

The Serbian economy recorded a larger fall in production during the 1990s than took place in the transitional countries being considered.. With the start of stabilization and reforms Serbia achieved growth in production, while the recession was felt partly in industry (see Table 2). It follows that the economy has gone through transitional recession and that it can ascend onto the path of medium-term growth. A decisive element for the achievement of high medium-term growth is that the growth is continuous, that is to prevent either a balance

of payments or an exchange rate crisis, i.e. a fiscal crisis that would tip the economy into recession.

Comprehensive econometric research of transition economies shows that basic determinants of their growth were: a low inflation rate, a decrease in public spending, and reforms. A decrease in the inflation rate, i.e. establishment of macroeconomic stability, led to the increase in the growth rate. The influence of public spending on growth is shown in the relative (in terms of GDP) size of the fiscal deficit, i.e. moderate public spending. It was confirmed that a larger fiscal deficit, i.e. relatively higher public spending, causes a decrease in the rate of growth. Finally, structural reforms led to the acceleration of growth. The degree of liberalization, the index of small and medium enterprise privatisation, private sector share in GDP etc. were used as reform indicators. Empirical research also explained the phenomenon of transitional recession: reforms at first lead to a decrease in the growth rate, and later to its increase.

Based on the correlations for the sample set of transition economies, it is possible roughly to project the potential growth rate of Serbia's economy, bearing in mind the previously stated presuppositions on macroeconomic stabilization and public spending (Table 6), as well as on the corresponding dynamics of reforms. Since the largest part of the fiscal deficit will be financed from privatisation income, while only a small part will be covered by loans, i.e. non-inflationary sources, it follows that the inflation rate can be significantly reduced from 19% in 2002 (Table 2) to 5% after 2005. The reform dynamics are planned in such a way as to achieve the level of "weaker" EU membership candidates in 2006. Such dynamics of fiscal and macroeconomic adjustment on the one hand and of structural reforms on the other show, on the basis of the experience of other transitional economies, that medium-term average growth in Serbia of 5% a year is ambitious but feasible.

### **Public investments in infrastructure**

A part of the total investments, which are to support medium-term growth, are public investments. They are only a small part of overall investment, but apart from their direct impact on growth in production, they also have an indirect effect through creating a favourable environment for investment and growth in production. The share of capital expenditure in the public expenditure of Serbia is low. Therefore, above-average growth is planned for the medium-term period. There should be a relative increase from 2% to 4% in the share of GDP, thus achieving a level comparable to international standards.

It is estimated that around one third of the overall investment<sup>55</sup> in Serbia in the period 2004-2006 will be directed to infrastructure (transport, energy, telecommunications, postal service, utility infrastructure). These investments will be financed from:

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<sup>55</sup> Infrastructure share in GDP is relatively high due to its deteriorated state and the fact that these are actually capital intensive sectors.

- Resources of the enterprises in the above-mentioned sectors (their own resources and commercial loans),
- Budgetary resources (republic and local budgets), and
- Expected donor funds and soft loans.

It is estimated that the entire necessary resources for investing in telecommunications and the postal service will be provided from commercial sources (national and borrowed). Modernization and construction in other infrastructure activities will to a great extent depend on budgetary resources, donor funds and soft loans.

According to the assessments, the allocations from budgetary resources (republic and local budgets) for infrastructure (transport, energy and utilities) and housing in the next three years will amount to 2% of GDP on average, which equals around two thirds of the overall budgetary investments. Apart from infrastructure, some 1% of GDP will be allocated from budgetary resources for health care, education, public administration, and security.

The resources of enterprises from these sectors, as well as budgetary resources, are not sufficient investments, and the financial performance of enterprises and of the state do not allow for borrowing under commercial terms. The decrease in donor funding and soft loans would considerably slow down the investments, which would in turn hinder the modernization of these sectors. Besides infrastructure, housing also requires soft loans. Such loans would have multiple positive impacts on economic activity and employment. The share of donor funding and soft loans amounts to some 20% of the overall infrastructure investments.

### **Foreign direct investments**

Foreign direct investments are the crucial element for sustainable medium-term growth. They directly contribute to the growth of production, and they make it possible to establish external and partly internal balances in the medium term. Thus, in the previous projections foreign direct investments are the main source for covering the current balance of payments deficit. They also generate large growth in exports, as shown in the experience of transitional economies. A significant growth in exports and financing of the current balance are the main planks of the medium-term foreign economic sustainability of Serbia. Foreign direct investments, through tender privatisation, will represent a significant source of fiscal deficit coverage, which will contribute to the establishment of the internal balance in the medium term.

**Table 9. - Cumulative foreign direct investment (FDI) per capita (USD)**

		<b>FDI p.c. (USD) 1989-2002.</b>
1.	Czech Republic	3413
2.	Slovakia	1784
3.	Slovenia	1722
*4.	<b>Serbia and Montenegro</b>	<b>1610</b>
5.	Hungary	1336
6.	Poland	997

\*Cumulative FDI p.c. for Serbia and Montenegro pertains to the period 1997-2010.

		<b>FDI p.c. (USD) 1989-2002</b>
1.	Croatia	1568
*2.	<b>Serbia and Montenegro</b>	<b>903</b>
3.	Bulgaria	547
4.	Romania	405

\* Cumulative FDI p.c. for Serbia and Montenegro pertains to the period 1997-2006.

The projected level of foreign direct investment, as already mentioned, is approximately 1.3 – 1.6 billion USD, that is, around 5-6% of GDP. In order to assess the amount of foreign investment, we compare cumulative values per capita for the preceding period (1989 – 2002) in advanced transitional states with the projections for Serbia and Montenegro (1997 – 2010). We also compare investment planned for Serbia and Montenegro until 2006 with total realized investment in less advanced transitional economies.

**Table 10.**

%GDP

	<b>Bulgaria</b>	<b>Romania</b>	<b>Croatia</b>	<b>Hungary</b>
<b>Exports/GDP in 2001</b>	55.7	33.5	46.7	60.5

There is scope for many improvements in this area, taking into account the extremely low levels of Serbian exports. The projected considerable rise in exports from 19% of GDP to 35% in 2010 means, for example, that Serbian exports in 2006 should reach over 6 billion dollars, which roughly corresponds to the amount of exports achieved in 1990. Comparison with the neighbouring economies (Table 10) also shows that the planned rise in exports can be achieved and this, together with foreign direct investment, presents the main strategic option for Serbian economic development.

## **2. Fiscal Limitations in Poverty Reduction Strategy Implementation**

### Introduction

An effective public fiscal management process is critical for ensuring the success of PRSP implementation. In particular, the budget and fiscal management system should be the main tool through which public expenditure implications of PRSP policies are translated into budget activities.

## **2.1. Recent Trends in Fiscal Policy**

Substantial fiscal adjustment has taken place in the last two years within the context of the stabilisation programme begun by the government in 2001. Fiscal adjustment involves redefining the role of government (away from being the direct producer of goods and services towards providing social security, investing in and maintaining economic infrastructure, and establishing a legislative and regulatory framework for private sector activity), incorporating all public sector expenditure into the budgetary process, reducing budgetary arrears and fiscal gaps in social insurance funds, as well as increasing revenue mobilisation.

The purpose of this fiscal adjustment has been to constrain the fiscal deficit. Subsidies to enterprises and capital investment have been reduced, whilst transfers to the population, in the form of social benefits, have increased in importance. Nonetheless, implicit subsidies to enterprises remain.

## **2.2. Recent Trends in Public Revenues**

Consolidated public revenues in Serbia in 2002 reached the level of 42.7% of GDP which is somewhat higher than other countries in the region<sup>56</sup>. The share of consolidated public revenue in GDP in Serbia is probably somewhat over-stated due to the under-stating of GDP because of the incomplete inclusion of the private sector and the greater extent of the grey economy in relation to the comparison countries. Based on the share of the consolidated public revenues in GDP, one can conclude that the tax burden in Serbia, compared with other European transition countries, is moderate.<sup>57</sup> With the exception of the contribution on salaries, one can make the same conclusion by comparing tax rates of other transition countries. The uniform sales tax rate is 20% (considering exemptions, the average weighted rate amounts to 16%-17%), the rate of the tax on salaries is 14%, and contributions on employee and employer's salaries are 33.6%.

Within the structure of public revenue in Serbia, taxes and contributions on salaries dominate (approximately 15.5% of GDP) and consumption taxes (close to 15% of GDP). The share of corporate income taxes is substantially smaller than in other countries in transition.

In 2002 the share of public revenue in Serbia's GDP increased by five percentage points compared to the 2001 level. The main generator of this growth in the share of public revenue is the increase in payments made, which is especially evident with sales tax and excise

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<sup>56</sup> Less successful transition countries exhibit a lower level of public revenues in terms of GDP than more successful countries. This is due to the fact that, either these countries are less developed, or that the basic governmental functions, including the ability to collect public revenue, are at a very low level.

<sup>57</sup> As compared to the countries of Asia, Africa and Central America that are at the same development level, the tax burden in Serbia is high.

duties. In addition to the increase in the number of payments made, the abolition of discretionary exemptions and reductions in the tax base for particular sectors and companies also contributed to the growth of public revenue share in GDP. The increase in the share of customs revenues, despite the significant decrease in customs rates, is a consequence of the increase in the value of import share in GDP as well as the increase in the share of consumer goods in the imports.

The planned fall in the share of public revenue in GDP in 2003 is a consequence of fiscal relief of the economy that was implemented in the second part of 2002, and above all else includes:

- Significant decrease in tax rates on financial transactions and the exemption of loan transactions from payment of this tax;
- Decrease in tax rates on gain from 20% to 14% and the introduction of significant incentives for investment and employment;
- Expansion of exemptions from sales tax.

Furthermore in 2003 growth in the level of payment collection is expected, especially on retail sales tax, due to the introduction of the obligation to issue and receive bills as well as the introduction of fiscal cash registers.

**Table 1. Consolidated public revenues** % GDP

	<b>2001</b>	<b>2002</b>	<b>2003</b>
	<b>Realization</b>	<b>Realization</b>	<b>Plan</b>
<b>Revenue</b>	38.0	42.7	42.4
<b>I Current revenue (1. +2.)</b>	38.0	42.7	42.4
<b>1. Tax revenue (1.1+...+1.10)</b>	36.2	40.6	40.2
<b>1.1. Customs</b>	2.0	2.6	2.3
<b>1.2. Personal income tax</b>	4.5	5.1	5.2
<b>1.3. Corporate income tax</b>	0.5	0.5	0.5
<b>1.4. Retail sales tax</b>	9.9	11.1	11.6
<b>1.5. Excises</b>	3.6	4.7	4.9
<b>1.6. Property tax</b>	0.3	0.4	0.4
<b>1.7. Financial transaction tax</b>	1.4	1.1	0.3
<b>1.8. Extra profit tax</b>	0.2	0.3	0.0
<b>1.9. Other taxes</b>	3.4	4.3	4.2
<b>1.10. Social insurance contributions</b>	10.4	10.5	10.7
<b>2. Non-taxable revenue</b>	1.8	2.0	2.1
<b>II Capital revenue</b>	0.0	0.0	0.0

## Recent Trends in Public Expenditures

The share of public expenditures in GDP in 2002 in Serbia closely corresponds to the level that successful countries in transition (Hungary, Czech Republic, Poland, Slovenia and Slovakia) had in the mid-nineties. Within the structure of public expenditure<sup>58</sup> by economic classification the most significant share was that of pension expenditures and social programmes, as well as expenditure for salaries. In comparison to successful countries in transition Serbia had an above average share in expenditure related to earnings and pensions, while the share of expenditures related to interest rates and capital investment was below average.

The share of consolidated public expenditures in GDP in 2002 increased by 6.4 percentage points compared to the previous year. Observed from the point of view of economic classification, the main generators of growth of public spending are the increase in pensions, salaries, reconstruction costs and servicing of debts.<sup>59</sup> In the case of pensions, the growth in share is the consequence of what is referred to as transferred growth<sup>60</sup>, while for salaries a significant factor is the slower growth of prices than projected (it was agreed with trade unions to increase salaries in accordance with the projected growth of prices).

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<sup>58</sup> The introduction of a system for evidence and classification of public revenues and expenditures in accordance with international standards started during 2002. Because there are still adjustments being made to the system, and at the level of local communities it is just being introduced, data regarding the structure of expenditures are still unreliable. For example, according to data from local communities expenditures for subsidies grew constantly from 2000-2002, despite significant elimination of the disparity of prices for utility services. It is assumed that in the case of local communities there is a significant part of capital investment that is shown as subsidies.

<sup>59</sup> The data on the public expenditure structure in 2001 and 2002, by economic and functional classification, have changed compared to the first version based on final data on execution of budget and funds for 2001 and corrected budget and funds reports for 2002. With the revision of the Serbian budget for 2003, which includes also expenditures of the whole SAM financed from public revenues in Serbia and Montenegro, the planned structure of public expenditure for 2003 was changed.

<sup>60</sup> The scope of implementation of the so-called Swiss formula for pension indexation was to provide slower pension growth than GDP growth. However, the average salary in 2002 grew twice as fast as GDP, resulting in faster growth of average pensions than that of the GDP.

**Table 2. Consolidated public expenditures – economic classification % GDP**

	<b>2001</b>	<b>2002</b>	<b>2003</b>
<b>Total</b>	39.3	45.9	45.9
<b>1. Salaries</b>	8.7	10.1	10.3
<b>2. Purchase of goods and services</b>	6.7	7.0	7.0
<b>3. Pensions</b>	9.4	11.7	11.7
<b>4. Social protection</b>	3.2	4.1	4.0
<b>5. Subsidies and restructuring</b>	5.7	6.3	6.2
<b>6. Capital investment</b>	1.3	2.0	2.1
<b>7. Public debt servicing</b>	1.7	2.1	2.5
<b>7.1. Interest</b>	0.8	0.9	1.3
<b>7.2. Paying of debt</b>	0.9	1.2	1.2
<b>8. Other expenditures</b>	2.6	2.6	2.1

In comparison to other countries in transition, in 2002 Serbia had an above average share in expenditure for defence, while the education expenditure was below average<sup>61</sup>. Expenditures for health and social care are at the level of the average for the region.

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<sup>61</sup> By adding the expenditures for education that are financed from the budget of local communities this deficit would decrease, but probably would not be eliminated.

**Table 3. Consolidated public expenditures - functional classification**  
% GDP

	2001	2002	2003
<b>I Total expenditures (1. +...+10.)</b>	39.3	45.9	45.9
<b>1. General public services</b>	4.4	5	5
<b>2. Defence</b>	3.6	3.4	3.3
<b>3. Public order and safety</b>	2.6	2.7	2.8
<b>4. Economic affairs</b>	3.8	4.3	3.5
<b>5. Environment protection</b>	0.0	0.1	0.1
<b>6. Housing construction and utilities</b>	2.6	3.6	3.4
<b>7. Health<sup>62</sup></b>	4.6	5.2	5.3
<b>8. Recreation, culture and religion</b>	0.5	0.6	0.7
<b>9. Education</b>	2.7	3.4	3.8
<b>10. Social protection and pensions</b>	14.5	17.6	18

In the first two years of transition Serbia achieved a relatively low level of fiscal deficit in comparison to other countries at the beginning of transition. The low level of fiscal deficit in 2001 is a consequence mainly of the better collection of public revenue than planned and the absence of foreign debt servicing, while in 2002 the main cause of the low level of deficit is the commitment to solid fiscal policy, which creates a favourable base for macroeconomic stability and growth.

A slight increase in the deficit since 2001 has been facilitated by the increase in availability of external resources and receipts from the privatisation process. Nonetheless, government policy is to keep the deficit at or below 3% of GDP.

**Table 4. Total and primary fiscal deficit** % GDP

	2001	2002	2003
<b>Total deficit</b>	-1.3	-3.3	-3.5
<b>Primary deficit</b>	-0.5	-2.4	-2.2

The total estimated domestic and foreign public debt at the end of 2002 was approximately 14.2 billion USD, which is 92.2 % of GDP. This total includes the sum of the unregulated debts (London club, debts to other countries that are not a part of the Paris club as well as the total sum of foreign debt from the region of Kosovo and Metohija). It is estimated that, upon reprogramming, these debts will be partly written off whereupon the relation between the

<sup>62</sup> According to the estimate of World Bank experts, the health care expenditure share in GDP exceeds 6%, if the additional forms (such as health care expenditures at the local level and within the defence system) were included. This is above the average for Central and East European countries set at the level of 4.7% of GDP. Precise estimates of out-of-pocket health expenditures are still missing, though some surveys conducted on a small sample indicate that these expenditures range between 2 and 4% of GDP.

public debt and GDP will be 70-75%, depending on the reprogramming conditions. Furthermore economically consistent<sup>63</sup> servicing of the obligations of debtors from the region of Kosovo and Metohija would additionally decrease the ratio between the public debt and GDP.

### 2.1.1 Impact of Recent fiscal Trends on Poverty

Total expenditures for the protection of the poor in Serbia equal approximately 4% of GDP, which is close to the average value for countries in transition. The most significant item of social protection, not including pensions, is the expenditures for child protection. Following that are the expenditures for taking care of those who lost their jobs during the process of restructuring (transition fund), and the expenditures for assistance to the unemployed and families living in poverty.

**Table 5. Expenditure for protection of the poor in Serbia**

	% GDP		
	2001	2002	2003 (plan)
<b>Social protection total (1+2)</b>	3.2	4.1	4.0
<b>1. Social protection from Serbian budget</b>	2.3	2.9	3.1
<b>One off aid</b>	0.1	0.0	0.0
<b>Social protection for the poor</b>	0.3	0.3	0.5
<b>Child care</b>	1.4	1.4	1.4
<b>Protection for the disabled and war veterans</b>	0.2	0.2	0.2
<b>Pupils</b>	0.0	0.0	0.1
<b>Students</b>	0.1	0.1	0.2
<b>Refugees</b>	0.1	0.1	0.1
<b>Social protection of employees within the public sector</b>	0.0	0.0	0.0
<b>Benefit fund for protection from natural disasters</b>	0.0	0.0	
<b>Transition fund</b>	0.1	0.6	0.7
<b>2. Social protection at other government levels (1)</b>	0.9	1.2	0.9
<b>From that for the unemployed</b>	0.5	0.5	0.5

1) This includes social expenditures at the federal level, at the level of local communities and the unemployment fund.

Changes in sales tax and income taxes during 2001 have had a direct impact on living standards and poverty.

The introduction of a uniform sales tax rate at the beginning of 2001 caused a one time increase in prices of basic vital products that were previously taxable at lower rates, which temporarily worsened the living standard of poorer classes. At the time that the uniform sales tax rate was introduced the only exemptions were for the purchase of bread and public

<sup>63</sup> This assumes that the servicing of debts from the region of Kosovo and Metohija for the most part is carried out from GDP realised in the region of Kosovo and Metohija.

utilities. The initial list of products that are free of sales tax was later expanded so that at the beginning of 2003 this tax exemption list included basic food products, utilities, basic medicine, etc.

At the introduction of Value Added Tax (VAT) in the first half of 2004, a decision will be made on the number of VAT rates (one or several rates, a uniform rate with exemptions for a certain number of products etc).

Decreases in taxes and contributions on salaries by ten percentage points had directly allowed an increase in average salaries by approximately 10% along with unchanged expenditures on work units. The growth of average salaries due to the decrease in fiscal burdens on salaries on average had more than compensated for the increase of expenditures because of the transfer to a uniform sales tax rate.

The beginning of state debt servicing toward the population (old foreign currency savings, large debt to pensioners) contributes to the alleviation of poverty. The relevance of government debt servicing toward the population is noticeable through the fact that in 2003 the total payments for this purpose will be approximately 1.7% of GDP. The social implications of public debt servicing are especially important due to the fact that a significant part of these debts are paid off to the poorer and older part of the population.

In the period 2004-2005 the third tax reform phase should be carried out, with the purpose of harmonizing the tax system of Serbia with tax systems of EU member countries.

### **2.3 Medium-Term Expenditure Framework**

The Government's medium-term fiscal policy is to maintain fiscal stability through further fiscal tightening, ensuring better use of existing resources, increasing revenue mobilisation, and providing tax incentives and other reform measures designed to stimulate business activity.

The medium-term fiscal parameters are intended to be based on the Ministry of Finance's medium-term budgetary framework, set out in the Budget Memorandum which was approved in June 2003. These included, for the first time, sectoral expenditure ceilings for the 2004-2006 period, consistent with a realistic overall resource framework, within which sector ministries are expected to contain their budget requests.

The main objectives for the setting of the basic MTEF fiscal parameters for the medium term include:

- Lower recurrent spending to make more room for greater investment provision.
- Ensure no arrears and settle any existing arrears.
- Tax relief (expanding the list of vital products and services exempted from the sales tax).

- Tax relief to stimulate investment.
- Decrease subventions.
- Faster real increases in wages for priority sectors.

It is necessary for the level of public expenditure within the medium-term period to be defined in a way that supports<sup>64</sup> the implementation of the most significant macroeconomic goals - fast growth and economic stability. This implies lower tax rates to encourage domestic and foreign investors. Low taxes and a sustainable deficit imply a level of consolidated fiscal expenditures that could in the medium term, at best, reach the level of the regional average. More precisely, the medium-term framework should provide for the realisation of long-term sustainable fiscal policy and state solvency. State solvency is usually expressed through the condition that the discount value of future primary surpluses be larger or equal to current values of the public debt. Fulfilling this condition practically means that gradual decreases in the primary deficit and its transfer into the zone of positive values (primary surplus) must necessary be planned within the framework of medium-term projections<sup>65</sup>.

The decrease in the share of the public debt to less than 60% of GDP represents an indication that long-term fiscal sustainability is secured. With the assumption that the existing debt toward the London Club and government creditors is written off to a significant extent and that the question of debt for the region of Kosovo and Metohija be solved in an appropriate manner, the public debt in the second part of this decade would fall below 60% of GDP. The realization of revenue from privatisation of 2-3% of GDP, would allow for the larger part of the fiscal deficit to be covered by non-credit resources in the next couple of years, primarily from privatisation revenue. Considering that foreign and domestic debts will be rapidly paid off within that time period, this would allow for the decrease in the absolute level of public debt.

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<sup>64</sup> It is mandatory that the projections of the scope and structure of public spending displayed in this document be treated as unofficial and preliminary. The Republic Ministry of Finance and Economy, in collaboration with other ministries, is developing a medium-term plan of optimisation of public spending in Serbia. It is expected that a draft version will be proposed by the end of April, and that the final version will be developed by the middle of 2003. Only after the adoption of the medium-term plan will it be possible to treat a specific level and structure of public spending as a goal from the aspect of state policy.

<sup>65</sup> According to the standard definition, primary deficit is equal to total deficit reduced by interest rate expenditures. When used as a measurement of long-term sustainability it is necessary to reduce the primary deficit by non-credit sources used for government financing - income from privatisation and donations.

The medium term fiscal framework includes the expected and planned changes in the structure of public spending. Changes in the structure of public spending are partly exogenously given. For example, adopting a Law on Domestic Public Debt Servicing (old foreign currency savings, Jugoskandik, Dafiment) as well as signing the agreement on reprogramming with foreign creditors as a whole defines the expenditures on the basis of current public debt servicing. Other changes reflect the priority changes (decrease in military share and increase in the share of education and capital investment in GDP), increase in productivity in the public non-profit sector (decrease in the share of labour costs in GDP), coordination of rights with economic possibilities and population (pensions), and progress in privatisation and economic restructuring (subsidy and restructuring expenditures). In some cases the contribution of specific sectors in GDP will remain fairly steady but within the future period there will be intensive changes within the sector itself. This is, for example, the case with health care whose total expenditures, financed by the state will increase by the same rate as GDP, but there will be significant changes within the sector that will result in better quality service and higher productivity (rationalization of institutional network, reducing number of employees, better equipment).

Basic changes within the structure of public expenditures considered from the point of view of economic classification are relative decreases in the share of salaries, pensions, subsidies, restructuring expenditures and social protection, and the increase in the share of capital investments and the expenditures related to public debt servicing.

**Table 6. Consolidated public expenditures - economic classification** % GDP

	2003	2004	2005	2006	2007	2008	2009	2010
<b>Total</b>	45.9	45.6	45.2	44.8	44.3	43.9	43.5	43.1
<b>1. Salaries</b>	10.3	10.0	9.8	9.7	9.6	9.5	9.3	9.3
<b>2. Purchase of goods and services</b>	7.0	7.0	7.1	7.1	7.1	7.1	7.1	7.1
<b>3. Pensions</b>	11.7	11.8	11.5	11.2	10.9	10.6	10.4	10.1
<b>4. Social protection</b>	4.0	3.8	3.7	3.6	3.5	3.4	3.1	3.1
<b>5. Subsidies and restructuring</b>	6.2	5.0	4.5	4.0	3.5	3.0	2.8	2.8
<b>6. Capital expenditures</b>	2.1	2.5	3.0	3.2	3.3	3.6	3.8	4.0
<b>7. Public debt servicing</b>	2.5	3.5	3.6	4.0	4.4	4.7	4.9	4.5
<b>7.1. Interest payments</b>	1.3	1.6	1.6	1.9	2.0	1.9	1.9	1.8
<b>7.2. Paying off debt</b>	1.2	1.9	2.0	2.1	2.4	2.7	3.0	2.7
<b>8. Other expenditures</b>	2.1	2.0	2.0	2.0	2.0	2.1	2.1	2.2

With reference to the points outlined above it seems that the implementation of sustainable fiscal policy (low tax rates, low fiscal deficit, decrease of the ratio between GDP and public debt, larger expenditures for education, etc.) requires a gradual reduction of public expenditure intended for the social protection of the poor.

The reduction of social protection expenditure share in GDP in 2006 compared to 2003 would amount to 0.4 percentage points. Considering the estimated growth of GDP by 4-5% in the period 2003-2006, the above-mentioned reduction of expenditure for social protection

implies its real growth at the rate of 1.4% annually. Given that the most important rights within social protection are index-linked to the cost of living, the expenditure for social protection per beneficiary would remain unchanged in real terms. The increasing of the expenditure amount along with a constant level of expenditure per beneficiary (other conditions remaining unchanged) enable the growth in the number of beneficiaries (vulnerable groups identified in the Poverty Reduction Strategy), that is, the introduction of new types of social protection. The expected gradual reduction of transitional forms of social protection (transition fund, severance payments) makes additional room for new beneficiaries, that is, new types of social welfare. Regarding economic purposes of expenditures for Poverty Reduction Strategy implementation, the dynamics of pension expenditures are relevant. The plan is to cut the share of pension expenditures in GDP by 0.5 percentage points by 2006. The basic assumption that this plan is based on is that the average pensions will grow in real terms by 2.5% annually, while GDP will grow by 5%. To achieve this it is necessary to provide the appropriate pension indexation rule.

Changes in the structure of public spending according to functional classification include the decrease in the share of expenditures for defence, social expenditures and the growth of the share of expenditures for economic issues, education, health care and public services.

Concerning the implementation of the Poverty Reduction Strategy, changes in health care and education expenditure are relevant. According to the plan, by 2006 the share of health care expenditure in GDP will increase by 0.2 percentage points, while education expenditure will increase by 0.4 percentage points. Taking into account the projected growth of GDP of 5% annually, health care expenditure growth in real terms would amount to an average of 6.3% annually, while growth in education expenditure would amount to 8.6%. However, in terms of optimization of public expenditure and the reform of these sectors, the change of expenditure structure within them is decisive. The expenditure structure change means in the first place that average salaries grow in real terms as fast as GDP (that is 4-5% annually), and, on the other side, that total labour costs grow more slowly than GDP because of the necessary reduction in the workforce.<sup>66</sup> In addition to the control of the real increase in salaries, it is necessary to make significant rationalizations of the network of health care and educational institutions. Fast real growth of the level of public expenditure for education and the school system, along with strict control of labour costs and rationalization of the network of health care and educational institutions would enable significant growth in expenditure intended for implementation of reforms and improvement of equipment in institutions in health care and education. All of the above-mentioned changes would result in improved quality of and better access to services in education and the school system.

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<sup>66</sup> Employees in health care and education make up over 60% of the total number of employees in the public non-profit sector. Therefore, a significant reduction of employees in the public non-profit sector is not possible without a reduction of employees in these activities. According to the research carried out by the World Bank on the sample of single hospitals and schools, there is a significant surplus of labour, especially unskilled labour.

**Table 7. Consolidated public expenditures -functional classification % GDP**

	2003	2004	2005	2006	2007	2008	2009	2010
<b>I Total expenditures (1. +...+10.)</b>	45.9	45.6	45.2	44.8	44.3	43.9	43.5	43.1
<b>1. General public services</b>	4.2	4.5	5.0	5.4	5.7	5.8	5.9	5.9
<b>2. Defence</b>	3.8	3.3	2.9	2.5	2.3	2.2	2.2	2.2
<b>3. Public order and safety</b>	2.8	2.7	2.5	2.3	2.2	2.2	2.1	2.1
<b>4. Economic affairs</b>	3.5	3.4	3.2	3.0	2.9	2.8	2.7	2.6
<b>5. Environment protection</b>	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
<b>6. Housing construction and utilities</b>	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
<b>7. Health care</b>	5.3	5.3	5.4	5.5	5.5	5.6	5.6	5.6
<b>8. Recreation, culture and religion</b>	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
<b>9. Education</b>	3.6	3.8	3.8	4.0	4.2	4.3	4.5	4.5
<b>10. Social protection and pensions</b>	18.0	17.8	17.6	17.3	16.7	16.2	15.7	15.4

**Table 8. Revenues, expenditures and deficit % GDP**

	2003	2004	2005	2006	2007	2008	2009	2010
<b>Consolidated revenues</b>	42.4	42.0	41.8	41.7	41.7	41.6	41.4	41.2
<b>Consolidated expenditures</b>	46.1	45.6	45.2	44.8	44.3	43.9	43.5	43.1
<b>Total deficit</b>	-3.7	-3.6	-3.4	-3.1	-2.6	-2.3	-2.1	-1.9
<b>Primary deficit</b>	-1.9	-1.4	-1.3	-1.0	-0.6	-0.3	-0.3	-0.1

The implementation of the outlined scope and structure of public spending involves a number of risks and uncertainties. The uncertainties are related to the non-existence of the officially adopted reform programmes for some of the main spenders of budget resources: health, education, defence, and internal security. There is also a significant portion of existing foreign debts (London club, debts toward Russia, China, Kuwait, Libya, etc.), that is not regulated and as a result the conditions of their servicing are still not known.

The basic risks in the implementation of a sustainable level of public spending are related to the following:

- Slower average GDP growth rate than projected,
- Significant one-off devaluation of the currency exchange rate,
- Significantly smaller influx of foreign investments than projected and lower income from the privatisation process,
- Expansion of potential government obligations based on the loans for reconstruction and restoration of the infrastructure,

- Impositions for war damages.

Some of these risks are interconnected so that with their appearance together a large number of negative scenarios could develop. For example, the low level of foreign investments combined with small amount of revenue from privatisation could generate economic stagnation with preserved stability or alternating periods of growth and recession.

#### **2.4. Fiscal reforms**

Sustained fiscal stability will be made possible only by the continuation of the process of fiscal reforms. The Government initiated the process of fiscal reform in order to improve the use of scarce public resources and ensure that Serbia's public finance system is suited to a modern and efficient public service within a market economy. Measures undertaken have included:

- Adoption of a modern Law on the Budget System based on international best practice, covering: (i) budget comprehensiveness; (ii) the introduction of a strategic budget phase in the overall process (prior to the start of the annual budget process); (iii) requirement for budgetary parameters to be medium-term in nature; (iv) strengthening of the functional/programme-related classification to facilitate the link between policies and budgets;
- Specification of a longer budget calendar which allows more time for analysis and scrutiny by Parliament;
- Adoption of Law on Public Procurement and formation of Public Procurement Agency;
- Implementation of wide-ranging tax reforms, including rationalisation of tax structure and improvements in tax administration;
- Improved budget format, based on an international standard classification structure;
- Reform of the payments system, including introduction of Treasury system;
- Better budget reporting required to Parliament and introduction of external audit of the budget;
- Stricter Parliamentary review of the financial plans for the extra-budgetary social Funds.

Thus, the budget system is introducing more rigorous professional and political verification of demands made by the budget users, as well as better correlation between the plans for spending and accepted social and macroeconomic goals. In the phase of budget implementation and plans for social insurance funds, the application of regulations decreases the possibility of abuse and waste of resources. The application of the law on public

procurement introduces competition into the buying of goods and services, which, with the given expenditures, secures better supply and quality of services. The application of this law is especially important from the point of view of social protection because it secures better quality services in health and education within the given level of expenditures.

The Government is committed to undertaking further fiscal reforms in order to ensure sustained fiscal and macro stability and to facilitate implementation of the PRSP.

- Further payment reforms, including expansion of Treasury operations;
- Strengthen tax administration, including establishing regional Large Tax Payers office and preparing for the introduction of VAT, improved tax audits and introduction of self-assessment;
- Continuation of tax reform measures including: (i) abolishing a large number of taxes that are unfavourable in terms of allocation, lack transparency, and impose high administrative requirements whilst at the same time failing to generate significant fiscal yields, e.g. financial operations tax; (ii) simplifying direct taxes, such as the income tax; (iii) increasing receipt of periodic property taxes and abolishing taxes on securities; and (iv) abolishing significant numbers of compensations and replacing them by appropriate taxes.
- Improve budget formulation, including: (i) introducing/strengthening a Medium-Term Expenditure Framework (MTEF) based on a comprehensive resource framework and three-year sectoral ceilings; and (ii) undertaking resource allocation reviews
- Other public expenditure reforms, including: adopting a new Pension Law to introduce more appropriate indexation of benefits and increasing the retirement age

As is discussed below, the budget should be the main mechanism through which the priorities of the PRSP are translated into funded activities. This will require development of the explicit link between budgets and policies/activities at the sector level. In particular, sector ministries will need to restructure their budgets by: (i) undertaking a strategic policy review/analysis for each sector and sub-sector, setting out the key policy objectives and priority policies for the sector/sub-sector; (ii) carrying out a detailed review of key expenditure programmes within sectors/sub-sectors, including a comprehensive analysis of the activities currently supported by budgetary resources; (iii) identifying measures to improve efficiency of resource use; and (iv) strengthening capacities for budget analysis and planning.

### **3. Transition to a market economy**

#### **3.1. Establishing conditions for private sector development**

##### **3.1.1. Reform and Economic Growth**

Theoretical and empirical research has shown that there is a significant link between reform and economic growth. The nature of the link between these two phenomena is such, that radical and all-inclusive reform aimed at the creation of an integral market (creating a real market economy) is a precondition for rapid economic growth. The key to this is that all-inclusive reform creates a business environment which is attractive for private capital investment, especially for foreign direct investment.

There are two important types of reforms:

- The first includes economic policy reforms which will facilitate the development of the market economy, encourage efficiency in resource allocation and attract new private investment, both domestic and foreign.
- The second is institutional reform, which should create new and stable rules of the game and lead to their consistent and unbiased enforcement.

In short, this institutional reform should lead to the creation of market and democratic institutions and should also establish the rule of law. All this leads to the reduction of transaction costs, especially in capital transactions. If this takes place in Serbia, more new private direct investments (especially foreign) may be expected.

The link between reform and economic growth, and thus the link between reform and poverty is of key importance for overcoming poverty. That is why it is important to answer the question of the sources of political incentives for the initiation, formulation and implementation of reforms. The political economy of reform considers different configurations of political forces (for and against reforms) as well as their political and reform outcomes.

The existence of different political forces is natural and expected. Reform measures are not neutral, there are both winners and losers, and individual welfare is also influenced. Along with the changes of phases within reform, the roles of winners and losers also change – those who profited from the first phase of the reform may become losers in the second phase. There are at least two types of losers. The first type are influential losers and the second are the ones who are not (usually the poor). From this point of view, one should be aware of the fact that powerful resources are available to the influential losers, which can be used to stop the reform at a level far from a fully-fledged market economy.

The experience of East European transition has shown that the biggest winners and advocates of reform are private entrepreneurs and the middle class and that maintaining the course of reform depends on the ability to create coalitions of interest within these two

groups. However, this would not have been possible if social consensus and a new form of social solidarity had not been established – different from the statist and protectionist solidarity that existed under socialism. An important element of this new awareness, i.e. cohesion, was the resistance of East European countries to Soviet domination, which had not existed in FRY.

From the perspective of the political economy of the reform, compared to the situation in most East European countries, there are particular circumstances in Serbia. The problem is that some of the reforms were conducted during the 1990s, before democracy was established. Influenced by the impending collapse of the old (socialist) regime, they lacked a clear concept and a wish to create a fully-developed market economy. The real reform started with the democratic changes in October 2000. The most significant reform policies were based on the well processed experiences of East European countries in transition. The first phase of this reform, based on the reform of economic policies, has been carried out over the last two years.

The reform started by forming a large reform coalition, which in time began to crumble. However, regardless of all the pragmatism needed for the implementation of reforms within the limited resource framework, stable democracy is necessary for building mechanisms and institutions that will additionally advance and maintain the basic social consensus.

The recent events (since 12 March 2003) constitute a new political turning point for the reform in Serbia. The assassination of the Prime Minister and the government reaction that followed created new political incentives, removing the limitations on conducting a complete institutional reform and enabling the reform of the justice system, the introduction of the rule of law and a resolute fight against organised crime.

### **3.1.2. Privatisation and restructuring of the real sector**

#### *Privatisation of the Real Sector*

The privatisation of the real sector in Serbia is being conducted by applying a model based on sales conducive to good corporate governance, with increased efficiency, attracting new investment. The model itself is relatively complex and requires a long period of preparation, not only for conducting the whole process but for every single transaction as well. Besides this model, privatisation of the real sector should include the completion of the privatisation of enterprises partially carried out under previous privatisation models.

Full privatisation, effected by creating concentrated private ownership, leads to the increase of enterprise efficiency, but very often at the cost of a lot of people losing their jobs. This consequence of privatisation has made government make quite strict demands on the “social programme” when applying the model for tenders, namely that investors provide for the surplus manpower. It is clear that such a demanding policy has shown negative results in attracting foreign investors, though it represented a good transitional model in terms of

reaching a social consensus, so important for Serbia. Therefore the new policy (starting with the recent change of the Law on Privatisation), will not be so demanding.

Concerning the acceleration of the privatisation process in Serbia, with the fixed institutional costs being already borne (creation of legislation and constitution of institutions), an acceleration of the process may be expected, especially the acceleration in auctions. Over the next two years privatisation of the state-owned enterprises can be expected.

### *Restructuring of the Real Sector*

According to the current privatisation programme, a number of large enterprises in Serbia (especially socially-owned holding companies), which have a long track record of financial losses, should be restructured prior to privatisation. It is estimated that restructuring is a precondition for successful privatisation through sales.

This type of restructuring means the fragmentation of such enterprises, in order to form a number of smaller enterprises. The basic idea is to create smaller enterprises with some business opportunities, which can be privatised, while the rest would be liquidated. Studies on the restructuring of large enterprises are being carried out, and it can be expected that, following the recommendations of these studies, pre-privatisation restructuring will be conducted in 2004. Since the restructuring is often linked to considerable political problems (risks) and manipulations, good programmes and persistent collective negotiations are needed to carry out this process successfully.

Short-term considerations show that restructuring will slow down the increase in production and cause decreases in employment. A large part of the unemployment which will be created is just hidden unemployment as shown by research on the informal economy and a number of employees of those enterprises are actually employed within the informal sector. The important thing is that, by the restructuring process, a healthy economic core is preserved and the reform dynamic accelerated. The long-term considerations show that liquidation of some of the existing enterprises, which are being restructured, will release resources (real capital in the first place) that can be used for new enterprises, especially small and medium, which will favourably influence economic growth and employment. In this way, the sections of the restructured enterprises with business opportunities will be able to make faster progress.

The new law on bankruptcy (to be adopted in the end of 2003) will significantly further the restructuring process by enabling the liquidation of enterprises which cannot be privatised due to the lack of business opportunities and accumulated debts.

### **3.1.3. Infrastructure and private sector growth**

Infrastructure is a precondition for economic growth. Inadequate supply of infrastructure services discourages investment, thus lowering economic growth rates and, in turn, fostering poverty. The phenomenon can be observed both at the national level (national infrastructure

systems such as telecommunications, the electrical power industry and highways) and at the local level, whether it is local branches of national infrastructure systems (such as local telecommunications networks) or public utility systems (such as water supply or heating).

Apart from an overall increase in the supply of infrastructure services, the problem can also be addressed by making the process itself more flexible, that is, by allowing for investor participation in the construction of the infrastructure network in keeping with his own needs. In addition, urban planning control of the realization of the investment needs to be more flexible in order to encourage investment.

The reform of infrastructure services, investment in them and the increase in their supply has, as has already been argued, a favourable direct and indirect impact on poverty alleviation. Moreover, construction work stemming from investment in infrastructure services increases the demand for unskilled (unemployed) labour, and the proportion of the poor in this group is above average.

The reform of infrastructure services in Serbia has just begun, so investment work so far has been mainly carried out on the renovation of existing infrastructure, financed from public resources. The reform requires a completely new legislature, new regulatory regime and specialized institutions to carry it out. So far these issues have not been given priority in the reform process in Serbia.

Reform in the area of infrastructure services allows for private investment, thereby raising their supply. Taking into account the low amount and poor quality of infrastructure services in Serbia together with the neglect they sustained during the 1990s, investment of private capital (probably mostly foreign) is the necessary precondition for their further development.

Pricing policy in the field of infrastructure services (electrical power and gas supply, water supply) is an important issue for the poor. In the case of electrical power, which is a key problem for them, it is suggested that all the prices should be increased through the reform of the tariff system to reflect the real (market) costs, while the poorest households should be granted subsidies, provided that they rationalize their consumption. At the same time, financial support for switching over to cheaper means of heating is envisaged<sup>67</sup>.

#### **3.1.4. Reform and Development of the Financial and Capital Market**

##### *Financial Sector*

Contemporary empirical research has shown that the development of the modern financial sector provides incentives for economic growth and enables a decrease in inequality in

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<sup>67</sup> See Annex for the Matrix of detailed objectives and activities for the reduction of energy poverty.

income distribution. This means that the development of the modern financial sector has a beneficial effect on poverty.

The inherited state of the banking sector in Serbia caused development to take place in two directions. One was bankruptcy and liquidation of the largest domestic insolvent banks. This was successfully accomplished and none of the predicted major problems occurred. The other was attracting foreign banks to establish new banks in our country. The entry of the foreign banks and the formation of completely new banks proceeded slowly. To some extent, this was because of the National Bank policy that insisted on the privatisation and possible take-over of the incumbent domestic banks.

Regardless of the results achieved, the supply of loans (under favourable conditions) for small and medium enterprises, i.e. small private entrepreneurs, is still modest. One of the causes is insufficiently developed mortgage legislation, which prevents the financial sector from obtaining solid security. This solid security would diminish investment risk, which would cause interest rates (risk dividend) to decrease. Adoption of the Law on Mortgage on Immovables entered into Registry, the Law on the Guarantee Fund, the Law on Financial Leasing, Law on Concession and their efficient application is very important for the further development of the financial sector and economic growth.

#### *Capital Market*

One of the basic preconditions for a fully operational market economy in Serbia is the creation of an efficient capital market. This means accelerated economic growth and a decrease in poverty. Creating an efficient institution of this kind enables efficient trade in stocks (securities), and efficient trade of property rights on capital. For the efficient allocation of capital as a factor of production, the protection of private property rights of a capital owner is crucial. This is also important for economic efficiency and dynamic economic growth. These two are the base for overcoming poverty.

It is also crucial that, as soon as possible, laws on investment funds and other laws regulating financial markets, as well as the new company law, should be enacted. These laws will enable better protection of capital owners (especially minority shareholders), and will improve corporate governance and capital investment.

### **3.1.5. Reform of the business environment**

#### *Establishing a conducive business environment*

With the aim of improving and stabilising the business environment, the Government of Serbia initiated an ambitious legal and administrative reform (see Annex – The Report on Legislative Activities of the Government of the Republic of Serbia). The main principle of the present reform is to bring Serbian legislation in line with European legislation, creating at the same time an environment conducive for economic growth within the private sector. The key elements of these reforms are securing and attracting foreign investment, increasing

local investment by removing legal and administrative obstacles to the establishment, registration and successful operation of businesses, including the simplification of the tax regime and inspection services. Full implementation of the Law on Public Procurement and adoption of the proposed set of anti-corruption and anti-trust laws are also important elements of this reform.

#### *Foreign trade liberalization*

Theoretical works and voluminous empirical research have shown that liberalisation of foreign trade leads to real income increases and the acceleration of economic growth, and it has a neutral effect on income distribution. That makes foreign trade liberalisation an important element of the strategy for overcoming poverty.

Foreign trade liberalisation in Serbia has stopped somewhere in the middle. After the initial reforms in 2000 and 2001, which led to the cancellation of non-tariff import barriers, lowering of the tariff rate, and simplification of the foreign trade transaction procedure, everything has come to a halt, so the rate of duties is still quite high. One of the causes was political pressure by certain domestic producers, whose low efficiency made it impossible for them to face import competition successfully. Further liberalisation may be expected during the process of foreign trade harmonisation between Serbia and Montenegro, i.e. the implementation of the harmonized Action Plan in the next two years, as well as in the process of joining the World Trade Organization which has been initiated. The effective liberalisation has also been achieved through numerous bilateral agreements on free trade zones with neighbouring countries as well as with other trading partners (such as the European Union, Russia, etc).

Foreign trade liberalization, i.e. the removal of export and import barriers, represents the key precondition for the establishment and strengthening of regional economic cooperation. This process commenced with the signing of bilateral free trade agreements, and it would be further strengthened by the creation of a regional customs union (probably by accession to the EU), which would make this region increasingly attractive for foreign direct investment and thus increase the rate of economic growth in Serbia.

#### *Product Market*

The most important reform of the Serbian product market is the introduction of new competition (antitrust) laws and the establishment of institutions to enforce these laws. This will enable the elimination of non-competitive market structures and behaviours (such as cartels), which will lower prices and increase the real income of all consumers, including the poor.

#### *Labour Market*

Institutional reforms of the labour market in Serbia should enable more efficient interaction of supply and demand for this factor. The first among the planned reforms is the reform of the Labour Market Office and the establishment of a network of employment agencies,

which should improve information exchange. In the field of labour demand the timely circulation of information is very important, as well as the creation of incentives for employers to hire more people. In the field of labour supply, labour mobility and adjustment are crucial, that is, the unemployed should be encouraged to adjust to market needs.

The legal basis of this reform is a new Law on Employment (2003). After that comes the hard work of building institutions, especially creating the network of employment agencies. Strengthening the rule of law in the economic sector

The rule of law is an important precondition for the protection of private property rights and the supervision of the execution of contracts. Only in this way will conditions be created for private capital investment and the acceleration of economic growth.. It is crucial that the rights of investors and creditors should be protected and not the rights of debtors. The present sluggish, inefficient, and even biased judiciary gives privileges to debtors rather than to creditors.

### ***3.1.6. Reform of Public Finances and Poverty***

Reform of the public finance system affects poverty in two ways. Direct effects are: the increase in the efficiency of income redistribution efficiency, so transfers to the poor are also more efficient, which reduces poverty. Indirect effects are the successfully reformed system of public finances and the policy of relatively low tax rates, i.e. low burdening of economic subjects, which are a significant part of an environment suitable for private capital investment. This increases economic growth as a basic precondition for overcoming poverty.

During the last two years in Serbia, some important moves have been made in the area of public finance reform, which were directed towards increased efficiency of revenue collection, controlled money flows and efficient management of public expenditures. In the field of revenues, sales tax rates were unified. In the field of expenditures, control of subsidies to large enterprises was established, and quasi fiscal deficits were eliminated.

All-inclusive institutional reform is still to be conducted, together with capacity building of the tax administration and the implementation of the radical tax reform, based primarily on the introduction of value added tax, as the basic form of indirect tax, which should generate significant fiscal revenue and reduce the scope of the grey (informal) economy. The acceleration of this reform will create an environment conducive to private investment, so that increases in the economic growth rate can be expected. This will certainly have positive effects on poverty reduction.

*During 2003 the formulation of a radical tax reform that should introduce significant changes into public finances has been taking place in Serbia. The basic element of the reform is the introduction of the Value Added Tax that should substitute for the sales tax as of 1<sup>st</sup> January 2004. In addition, this tax reform is expected to abolish a great number of taxes that are unfavourable in terms of allocation, lack transparency, and impose high administrative requirements while at the same time failing to generate significant fiscal yields, as is the case with the financial operations tax. Direct taxes, such as income tax, will be simplified and become easily collectable. The new policies in the field of property tax will result in the increase of the receipt of periodic property taxes and the abolition of taxes on securities. Finally, a great number of compensations (typical fiscal mechanisms inherited from socialism) should be abolished and replaced by appropriate taxes. The aforesaid changes, together with other elements of tax reform in Serbia that have not been specifically mentioned here, will enable the creation of a modern tax system to stimulate economic growth and create conditions for poverty reduction in Serbia.*

## **3.2. Building Strong Public Institutions**

### **3.2.1. Public Administration**

#### **Present Status and challenges**

The previous regime left Serbia with a legacy of politicised and fragmented administration, ill-suited to performing the framework-setting role that public administrations are expected to play in modern democracies.

With Serbia's transition to a market economy, the role of the government sector has fundamentally changed from one of providing all economic and social services to that of:

- ensuring an appropriate legislative and regulatory framework for economic activity, particularly by the private sector;
- providing an enabling environment (e.g. through reducing unnecessary bureaucratic impediments) to facilitate the development of a vibrant private sector; and
- either contracting or being the direct service provider in areas in which the market fails to produce the right level of services at a socially acceptable price (e.g. public health services).

The new role of the public sector should be focused on the delivery of key services as well as ensuring that the necessary framework is in place for the market to function in a satisfactory manner. This implies a close partnership between all stakeholders in society including all levels of government, the private and civil sector including the media, labour unions, employer associations, NGOs, etc. Such a government needs to be results-oriented, transparent and accountable with respect to both the delivery of services and the effective use of public resources. This implies the need to set clear standards within each area of public activities and establish continuous monitoring of the implementation of activities and projects.

The main goal of activities in the public sector is to meet citizens' needs. This implies active participation by citizens in the process of design, implementation and monitoring of services. Therefore, there is a need to affirm the approach based on citizens' needs.

Successful functioning of the system as a whole requires partnership and collaboration at all government levels (central and local), as well as teamwork. These relations imply strong decentralization of competences and finances, strengthening the rule of law by the state, the market model of the economy, and market principles.

A number of challenges face the public sector "central and line ministries and local administrations" in adapting to the needs of the market economy. These include:

- Frequent changes at the top (ministry level) often lead to changes in the senior managerial ranks (e.g. assistant ministers / heads of sections and to a lesser extent department heads). It is difficult for senior management to propose and implement institutional reform if they (and their staff) do not know how long they will be in post.
- High turnover of staff, which results in ministries and agencies being unable to hold on to key skills, particularly in new skill areas. Highly skilled staff, particularly senior policy and managerial staff, tend to be tempted away by the private sector, aid agencies or technical assistance projects to work as consultants.
- There is a lack of appropriate technical skills to match the new roles required by market reforms. This shortage of skills is exacerbated by the high turnover of staff, where those with appropriate skills have tended to leave the public sector faster than other staff.
- Demoralisation of staff, caused by low salaries, lack of resources to carry out the task at hand; no delegation of clear responsibility; lack of professional development and career opportunities, and frequent changes of senior staff. This is exacerbated by the lack of a functioning and neutral staff recruitment and promotion process.
- Weak management in ministries and agencies, which tends to be dominated by a hierarchical and command-and-control approach and lack of transparency and coherence in decision-making processes. Poorly targeted staff training.
- Ministry structures ill-suited to the needs of the public sector in a market economy. Over-emphasis on technical work and relatively limited attention paid to the development of policy and strategy.
- Weak co-ordination of initiatives, projects and information flow within and across sectors, and between government agencies and ministries working within the same or related fields.

- Weak central government co-ordination mechanisms, and limited capacity within the General Secretariat to support the leadership functions of the Prime Ministers and the Government in their collective efforts as a united body. This makes it demanding to co-ordinate, oversee and to ensure accountability.
- Since it has been important to launch reforms quickly in many individual areas of the administration, adequate attention may not always have been given to how various measures would affect each other and their total effect. As a result, a large number of new bodies and agencies have been established in addition to the existing administrative structure, and it has not been restructured and adapted. Consequently, in some cases, this has resulted in more complex administrative structures.
- Ensure an efficient and rapid implementation of new and revised legislation and thereby ensure a sufficient and clear institutionalisation of the reforms.

### **Goals and strategic directions**

An efficient public administration reform is a key condition for the successful and rapid transition of Serbia to a modern society with a viable economy.

A well-organized and competent public administration is a key factor for a successful integration into the European Union. The SAP and the EIp are the single most vital catalyst for reform during the coming period due both to their importance and to the massive task of making all legislative and administrative procedures compatible with EU standards and the “*acquis communautaire*”.

In response to these challenges, the Government has begun a number of initiatives in recent years. In particular, a number of new laws have either been put in place or are being prepared in order to modernise the public administration, including, the Law on General Administrative Procedures, the Law on Administrative Disputes, the Law on Administrative Courts, the Law on Public Administration and the Law on Civil Servants. However, implementation of these laws is weak due to fragmentation of responsibilities and unclear leadership. As a result, a single strategy for the overall public administration reform in Serbia has not been adopted. Thus, there is a risk that some of aspects of the above-mentioned laws will have to be revised if they are to be adopted before a strategy.

At the same time, a number of specific reform projects are taking place within some ministries, including the introduction of human resource management systems, the development of project management skills, the establishment of a change agent, and limited capacity building in ministries. However, these initiatives are not well co-ordinated and are not supported by the strengthening of central co-ordination mechanisms.

It is necessary to ensure the provision of a dynamic, efficient and transparent public administration which is well suited to the appropriate role of Government in a market economy and which will support the development of an active private sector through the provision of a transparent and accountable legislative and regulatory framework.

The strategy on public administration reform is being prepared, and includes the following elements:

- Strengthening the central co-ordination mechanisms of the Government including the support function of the PM and the Government with the objective of facilitating the effective and efficient performance of the Government's collective duties.
- Improving the pay and grading system. This will involve changing the pay structure, rationalising and/or introducing the grading system and reducing the overall public sector wage bill.
- Improving human resource management. This will include introducing transparent and merit-based systems of recruitment and promotion, review and appraisal. It will also include modern management structures and the development of staff training programmes. Strengthening public sector institutions is an integral part of the EU's Stabilisation and Accession Process (SAP).
- Improving the efficiency and relevance of ministries and agencies through restructuring and improvements in human capital development. These will follow functional reviews of institutions to identify the main aims and activities of each remaining ministry/agency, set out the appropriate structure which best meets these functions and the most suitable level of staffing and skill requirements, and identify efficiency measures.
- Strengthening anti-corruption measures to improve the delivery of basic public services. This will involve regularising out-of-pocket payments for services through setting, monitoring and enforcing the list of such fees and charges. It will also involve gradual increases in the salary levels of key public sector workers, within the context of the overall reform of the public sector salary structure.
- Improving communications within and across ministries and agencies through appropriate use of information technology.
- Strengthening public procurement. Following the adoption of the Law on Public Procurement, there is the need to adopt supporting procurement systems and procedures.
- Identifying a public administration reform champion. The establishment of a State Administration Reform Council within Government to act as a political/strategic decision-making is in progress.

- Establishing the function of an ombudsperson to act on behalf of the public in relation to state institutions and public services.

### **3.2.2. Corruption and Poverty**

The direct influence of corruption on poverty lies in the fact that public services, which should be a public good, become a paid service. The purchasing power of the poor is small so they are especially sensitive to the existence of corruption. They cannot afford expensive public services that should be free. In other words, corruption discriminates against the poor and has direct negative effects on poverty.

Corruption prevents the proper functioning of legally prescribed procedures for exercising rights, by enabling those who are well-off to exercise even rights they are not entitled to, while the poor, regardless of entitlement, are prevented from exercising their rights. Additionally, this weakens public trust in the impartiality and independence of government bodies, and blocks the operation of institutions.

The indirect effects of corruption on poverty are far more significant. In the first place,, corruption does not only involve redistribution in favour of the person carrying it out, it also incurs its own costs since a corrupt deal calls for real resources. This inevitably leads to economic inefficacy (lowering the effectiveness of resource allocation), since it incurs considerable transaction costs. These are, in turn, transferred to end users which leads to rises in prices and falls in the purchasing power of all consumers, especially the poor.

Theoretical and empirical research has shown that corruption decelerates economic growth by lowering its rate, and dynamic economic growth is the precondition for overcoming poverty. The basic cause of this effect is in the fact that a higher level of corruption discourages foreign investors, and has a significant influence on the total amount of investment and the growth rate; this is especially true for developing countries and states in transition. Discouraging investment reduces the economic growth rate with considerable unfavourable effects on poverty.

Finally, a special kind of corruption is political corruption which leads to state capture. In such cases individuals misuse executive and legislative powers in a corrupt manner in order to influence policies and laws in keeping with their own private interests rather than the interests of society as a whole. Policies and laws adopted in this way actually hamper economic development and drastically increase poverty.

Although comparisons of the intensity and the extent of corruption across different states are methodologically questionable, it is certain that Serbia has inherited a high level of corruption from the period preceding the political change in October 2000. Among the main causes of corruption in Serbia can be listed strong and far-reaching state intervention as well as inadequate state administration, that is, under-qualified and underpaid state officials having broad discretionary powers in the application of regulations.

At the very beginning of its term of office (January 2001) the first democratic Serbian Government announced the fight against corruption to be one of its priorities, though over time the declared and the actual course of politics moved in different directions. This especially holds true for the operation of the Anticorruption Council as the principal body in the suppression of corruption as well as for the preparation of anticorruption laws. However, the state of emergency declared after the president's assassination and energetic measures undertaken by the Government broke the main levers of organized crime and intensified the fight against corruption.

The non-governmental sector plays an important role in the suppression of corruption. As an example of this we can quote an action plan offered to the authorities by a non-governmental organization.

## Action Plan

A successful anti-corruption struggle demands a comprehensive approach, consistent and sustained effort and energetic execution resting on predetermined responsibilities and regulations. The main elements of the anti-corruption programme are:

1. Commitment: the main precondition of the anti-corruption effort is the commitment of the political elite in the state and all its bodies together with the firm resolve to undertake the necessary steps, resting on a full understanding of the negative influence that corruption has on the effective and just operation of the state administration and thus on economic, political and social life;
2. Accountability of the Serbian Assembly: The Serbian Assembly, as the representative of the will and sovereignty of the people, should be a bulwark against corruption and a guarantee of good rule; it has two main functions: as a legislative body and as a supervisory body for the work of executive authority;
3. Accountability of the Government: The Government of the Republic of Serbia is responsible for the operative work on suppression of corruption: it is obliged to give precedence to the fight against corruption, to carry it out continuously both through state institutions and through proposals for institutional reform;
4. Break with the past: the Government of Serbia should enquire into all major, known and unknown corrupt affairs from the previous period, so that perpetrators can be punished and made an example of, to all potential perpetrators;
5. Transparency: the operation of all state bodies and officials should be made transparent and public through the presence of the media at sessions, publication of reports made by state and other bodies, and similar actions;
6. Accountability: make everyone within the state administration accountable, from the government and other state bodies, through political parties and their leaders to each state official;
7. Reducing discretionary powers: carry out maximal deregulation of regulations wherever possible in order to reduce the discretionary powers of the state administration and limit the scope for possible corruption.
8. Laws: adopt anti-corruption laws and amend the penal code in order to define precise sanctions for corrupt behaviour and attempted corruption;
9. Public procurement: adopt the law on public procurement based on competitive methods (tenders, auctions etc), applying to all institutions financed from budget and state funds as well as for state enterprises;
10. Independent central control body: establish Main Control, an independent body exclusively linked to the Serbian Assembly which would supervise and inspect financial transactions from all budgets and all public enterprises as well as other similar tasks; investigation and sanctioning would be independent from the Government and subject to public scrutiny;
11. Anti-corruption Agency: establish a special anti-corruption body within the Serbian Assembly to coordinate anti-corruption efforts;
12. Other anti-corruption bodies: establish separate anti-corruption bodies within certain branches of the state administration such as the police force, the customs, taxation office, health service and others;
13. Administrative reform: reform the state administration in accordance with new laws on state administration and on administrative procedure;
14. Change in personnel: replace a certain proportion of state officials, especially in sensitive services (the customs, the police, judiciary, administration);
15. Judiciary reform: reform the judicial system so as to extend its independence from executive authority and political parties and their leaders;
16. Police force reform: strengthen internal control, special training, code of ethics;
17. International law: join the OECD Convention for the Suppression of Bribery from 1997;
18. International cooperation: secure the cooperation of all state and other institutions and organizations of civil society with partners from abroad in a struggle against corruption;

19. Education: long-term and short-term training activities for specialized services, state officials and the public on the causes, consequences and methods of fighting corruption; introducing certain relevant matters into school programmes;
  20. Ethical standards: develop ethical standards of proper conduct and include them in regulations;
  21. Free media: free media play an important role in exerting anti-corruption pressure on state officials and fostering awareness of the manifestations, depth and consequences of corruption; media campaigns can be organized, as well as various panels, documentaries about corruption in society, reports by relevant bodies on their activities, findings of research and similar.
  22. Advertising and field campaigns: for the promotion of the fight against corruption (posters in relevant institutions, badges with appropriate messages, fliers and other promotion material “a week of fighting against corruption” and similar.
  23. Research: promotion of continuous research and professional work on the issues posed by corruption, symposiums, seminars, publishing; the special role of empirical research on determining progress in the struggle against corruption through occasional opinion polls.
- Source: CLDS: Corruption in Serbia, 2001

### **3.2.3. Judicial System and Justice**

The state of emergency, established upon the assassination of the Prime Minister Zoran Đinđić, provided certain political incentives and removed some obstacles to the reform process. However, it is important for reform not to relate only to the criminal judiciary, i.e. the fight against organized crime, which has naturally been given priority, but also to the civil procedure, i.e. those parts that are crucial for regular and unhindered performance of business activities.

The importance of the state being based on the rule of law entails the creation of a system of norms that would enable the establishment of modern state institutions, implementation of decentralization, protection of basic human rights and liberties, building of democratic relations and strengthening of the independence of judicial authority whose reform should be oriented towards higher professionalism, depoliticisation, strengthening of ethical codes and modernization.

Accessibility to justice is one of the key dimensions of social welfare and poverty reduction, and it has a strong impact on citizens' satisfaction and their identification with the legal, political and social system. This area represents a big reservoir to draw on for the humanization of society and its democratisation, but is also an area of strong conflicts of interests and power. Many obstacles and much resistance can therefore be expected regarding reforms in this area.

The authoritarian regime which ruled by abusing rights has left as its legacy long-lasting disorder and the absence of the rule of law, it disrupted the principle of the hierarchy and subordination of legal acts, and promoted a proliferation of legal regulations and imprecise and conflicting legal norms and loopholes in the law, which created a wide area for arbitrary decision-making, for great discretion in evaluations and thus also for abuse.

Many holders of judicial functions and activities agreed to political intervention and influence, departing from the rules of the profession, and thus reducing the law to the position of servant to daily politics and the political interests of the authorities.

Such a state of affairs has provoked a deep crisis in the law and the principles of justice. Long-standing negative experiences of citizens related to corruption in this sphere, to different abuses of the law and numerous injustices, resulted in a loss of confidence that values of freedom, equality and justice are attainable. Such a state of injustice has led to the decline of citizens' legal awareness. Citizens today have a poor knowledge of legal principles and procedures, they hardly know their rights and the methods and mechanisms they can use for exercising these rights.

**The strategy of judicial system reform** as a universal guarantor of constitutional values implies the adoption of the Constitution and positive laws in harmony with international standards by means of which the legal system is established and basic rights and liberties of citizens are protected, which indirectly means strengthening the principle of the rule of law. The reform includes separation of the judicial branch of authority from the legislative and executive branch, as well as strengthening the independence of judicial authority, raising the quality and effectiveness of the work of courts and other judicial bodies and the emancipation of the judicial professions. This would enable the exercise of rights guaranteed by international instruments that are linked to judicial procedure.

An important part of this reform is the protection of citizens by the Constitution and laws, modernization of the courts and simplification of the procedure, depoliticising of the work of the courts, professionalisation, and strengthening of the system of continuous professional training. Intensive training of judiciary representatives on the application of international norms would lead to the efficient implementation of these norms and improve public awareness of the significance of human rights.

Citizens become the focus of the judicial system and reform has to bring them improved access to courts, a rise in the quality and effectiveness of court proceedings, greater accessibility to justice, and sufficient scope for the evaluation of the performance of judicial bodies..

### **3.2.3.1. Range of judicial reforms**

In early 2002 a set of five laws relating to the judiciary came into force, designed with the active participation of experts and with respect for professional knowledge, principles and standards, as well as European standards. These Laws are the following: the Law on the Court System, the Law on the Judiciary, the Law on the Judiciary High Council, the Law on Public Prosecution, and the Law on Headquarters and Areas of Courts and Public Prosecutors. These Laws have regulated all-important issues in a new way, providing the basis for demarcation between judicial and other spheres of authority, and thereby reinforcing the independence of the judiciary.

The Law on Courts determines the network of courts, their competences, organization, and modernization. Together with the Law on Ministries, this Law draws a line between judicial authority and executive and legislative authority. The Law on Courts increases the competence of first level courts in order to reduce the excessive work load of second level courts; it introduces the Court of Appeals and Administrative Tribunal, which represents a specific rationalization and modernization of the system.

These Laws adequately regulate the status of magistrates' courts, which were abused for years as semi-court, semi-administrative bodies for restricting and threatening basic human liberties ( including draconian punishment and persecution of the independent media, with arbitrary assessments by the magistrate judge on what "the truth" was, etc.).

In July 2002 the Law on Changes and Amendments to the Law on Judges was adopted. The Constitutional Court of the Republic of Serbia brought in a decision on the annulment of certain provisions of the Law; in March 2003 a new Law on Changes and Amendments to the Law on Judges was adopted, introducing partial changes to some of the questionable provisions (in accordance with the decision of Constitutional Court), while some provisions remained the same. Since in the field of legislation dealing with the organization and functioning of the judiciary some issues are not regulated, there is room for arbitrariness in the interpretation of norms and the assigning of excessive discretionary rights to the executive authorities compared to the judicial authorities.

#### **Status, election, dismissal and establishment of judges' accountability**

- The status of judges has been considerably strengthened and brought closer (although not made equal) to the status of parliamentarians or representatives of the executive authorities. The judges are guaranteed independence (real and material), job security (re-election is abolished and they are nominated for steady positions) . The new Laws have highlighted the principle of the political neutrality of judges and emphasized the ban on their party membership and involvement.
- The procedure for nominating presidents of courts and their deputies, judges, prosecutors and deputy prosecutors was set out, as well as the criteria and necessary qualities for their selection (expertise and worthiness), and it was put under the crucial influence of the legal profession. As in all developed states based on the rule of law, the right of candidacy was given to the High Judiciary Council as a body whose decisions guarantee the principles and criteria of expertise, since it consists of the most prominent judges, prosecutors, lawyers, experts and other representatives of the legal profession.
- The control of their work, disciplinary measures and dismissal of judges are specified by new Laws and put under the dominant influence of the legal profession, to prevent abuses of this extraordinarily important Law by everyday politics, which often happened previously (with imprecisely regulated conditions for dismissal, great discretion and arbitrariness in appraisal, dismissal without legal basis or explanation,

and application of shortened procedures for the dismissal of judges, etc.). The new Law introduced the Big Personal Council as an independent expert body consisting of 9 prominent judges from the Supreme Court; it is the main disciplinary body responsible for establishing the accountability of judges in respect of possible failings in performance and expertise, and to recommend adequate disciplinary measures.

- Partial restructuring has been carried out in a large number of courts; a great number of judges have been dismissed or resigned, as well as a number of prosecutors, with a public debate on procedures and methods of implementation and concerns about possible abuses.

### **Working Conditions of Juridical Bodies**

It is necessary to increase the independence of judicial authority in this sphere. The question arises regarding the conceptual place of the Prosecution and the Public Attorney's Office in the system, their attitude towards the Courts, the Executive authority and the Police, as well as their role in legal proceedings (increased efficiency, quality and independence in work). Many analyses pointed to the Prosecutor's Office as an operational bottleneck, which is exceptionally exposed to corruption.

The issue of greater material independence for the judiciary was also tackled making the judicial budget part of the state budget, with the active participation and greater influence of juridical bodies (High Judiciary Council) in determining its size in cooperation with the Ministry of Finance and the Government. Independent disposal of resources by juridical bodies will reduce the dependence of the judiciary on executive bodies that still have large competences in court financing, outlays, allotment of apartments, housing loans etc.

#### **3.2.3.2. Further steps**

- Adopting the new Constitution, and the forms of decentralization and regionalization, will require organizational and actual adjustment of judicial authority, but it will at the same time provide the best basis for full reform. Some of the most important issues are: the protection of basic human rights and independence of the judiciary, guaranteed also by the signed international agreements and declarations, as well as ensuring constitutionality and the rule of law with elaboration of the place of the constitutional judiciary in the system.

- Further strengthening of the independence of the judicial authority branch, raising the status of judges to that of parliamentarians and representatives of executive authority, introducing a judicial budget as a guarantor of greater material independence of the judicial authority, promoting a continuous process of education and training, as well as improving sensitivity about social issues and problems. In this context, the issue of the relationship between the Ministry of Justice and the judicial system (place, role and competences) should be dealt with consistently with standards appropriate for a state governed by the rule of law and with an independent judiciary.

- Improving the quality, professionalism and working efficiency, strengthening openness of work, improving material and technical working conditions of juridical bodies, creating anticorruption programmes. Introducing information technology (e-government) for increased transparency and higher accessibility to justice: automatic movement of documents, creation of functional databases accessible to citizens through websites for all areas (so far only the registry of companies has been organized as a functional database) etc.
- Reforms should encompass the entirety of process laws that would enable modernization and rationalization of work in this area (civil procedure, penal code, bankruptcy act, company act etc.) and simplify and accelerate these processes, along with strengthening the principle of parties' equality, banning discrimination in terms of the right to use one's native tongue in the court procedure, respecting the right to legal remedy etc. In these areas the interests of different groups often collide and therefore strong resistance is expected.
- The reform should introduce new professions, such as: notary public, magistrate, judiciary police, court crier, bankruptcy commissioner, and ombudsman. Their introduction requires the existence of schools for these professions, as well as permanent education and training.
- The codification of professional ethics is an exceptionally important part of this reform. It implies professionalisation, strengthening of ethical codes, and different attitudes towards citizens and parties as service users. Measuring the quality of work of juridical bodies, the satisfaction of citizens regarding "accessibility to justice", and continuous improvements to the quality and effectiveness of the work are important parts of this whole reform.
- Relations between the judiciary and citizens imply a restored public confidence in this branch of the authority. Cheap and easy access to the judiciary, the reduction and eradication of corruption, the control of the level of court fees (setting up the system of free-of-charge legal assistance) and exemption of socially vulnerable categories from payment of court fees (instituting rights for the poor) are some of the important principles of this reform. An important part of these processes is the continuous improvement in the public legal awareness along with disseminating knowledge about their rights and methods of exercising and protecting those rights.

### **3.2.4. Decentralization of Local Self-Government**

The new Constitution of the Republic of Serbia is currently being prepared. It is expected that this process will result in the new distribution of competences between different levels of government (Republic of Serbia, potential regions, local government).

The Poverty Reduction Strategy project in Serbia cannot not be successfully implemented if the relationship of cooperation and partnership between the State and the local governments has not been established. The problems of poverty can be identified most easily in the local communities, while the poverty reduction programmes could be created in the best possible way on the basis of suggestions from citizens, local organizations and NGOs, including the most efficient way of implementing such projects. At the same time, it is very important for

central government to be responsible for the promotion and development of mechanisms and activities oriented towards the poor at the national level, including sharing experience with local self-governments.

Local government authorities can establish more direct relations with the citizens, they can more easily move them and motivate them for the creation of private and public arrangements and partnerships, they can create an environment attractive for capital investment and for initiating different development projects. These competences and functions of the local authorities are among their most important competences and give them the opportunity to be entrepreneurial.

#### **3.2.4.1. Current status**

There is a general impression that adequate attention is not being paid to issues of social policy and poverty reduction in society, and concretely in municipalities, and also that there is no consistent strategy in this area.

The key legal framework meant to govern the operation of local government bodies is the Law on Local Self-Government enacted in February 2002, and the municipal charters in compliance with the above Law have been passed. This Law has just initiated decentralization, while the forthcoming constitutional reform is to create the normative basis for a further decentralization and a functional reform of all the governmental levels. The process of modernization, and strengthening the status and functional capacities of local government imply a new distribution of competences, and a new type of partnership among the various levels of government, new forms of coordination and the establishment of new financial arrangements, together with the strengthening of local government financial autonomy (fiscal federalism). Regulations on municipalities and other types of territorial organization, public administration, property, local finances etc. are a precondition of reform in this area.

#### **Local Government Competences**

The set of local government competences comprises all the key dimensions necessary to ensure the conditions for a better life for citizens. The new Law on Local Self-Government has expanded the scope of the original competences of local government, and it has precisely defined both the original competences and those newly entrusted to it. The significant original competences of municipalities include the provision of utility services such as the supply of water and gas, sewage, sanitation, collection and disposal of garbage, the traffic infrastructure and the road network, in addition to the areas of elementary education and primary health care, cultural institutions and activities, social services, sports, recreation, ecology and environmental protection and finally, stimulating economic development.

In the area of social care, to which the reduction and prevention of poverty belong, the municipal competencies have been transferred from the State to the municipal level, and such jobs are carried out under the supervision of State bodies. Moreover, the original

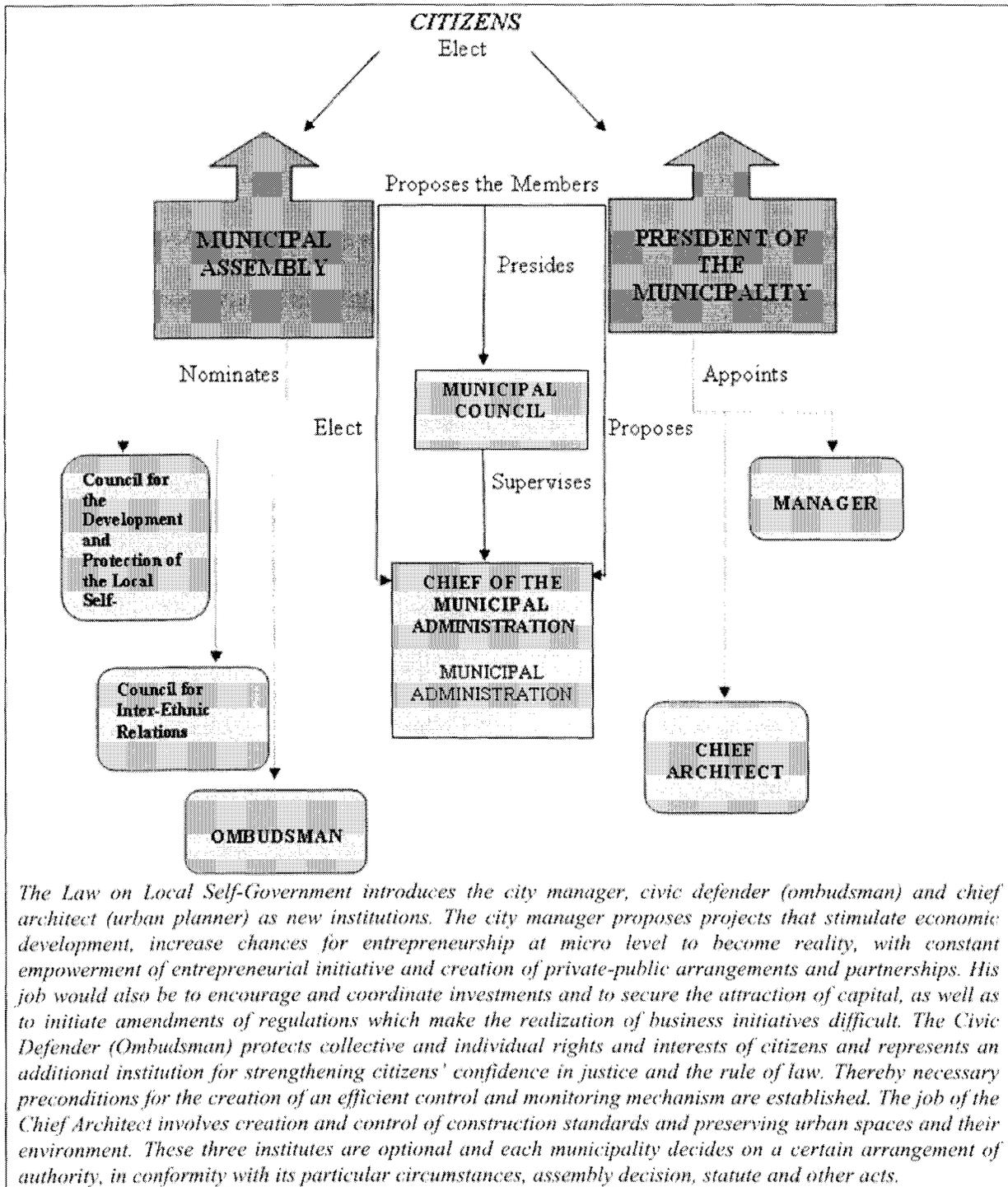
competencies of a municipality include the provision of the expanded entitlements of citizens, and also the development of specific forms of social care and protection. Substantial economic problems reduce the opportunities for major activities in that area.

The above range of competencies makes the local level an important starting point in the implementation of the Poverty Reduction project. The process of decentralization and transfer of competences to the local community level has an additional impact in terms of raising the responsibility of municipal authorities in the realization of human rights.

### **Organizational Structure and Functions of a Municipality**

The present organization of municipal authorities is a classical European assembly-mayor model, with strong elements of a system of unity of authority. The new Law on Local Self-Government, which will come into force on the occasion of the next local elections in 2004, provides for two new optional models of organization: the mayor-assembly model, and the assembly-manager model.

The following diagram illustrates the new organizational structure and relations among the most important bodies of a municipality.



In this way a certain organizational flexibility of the local government model is introduced, and the functioning of the entire institutional framework has been strengthened. In many cases, municipal administration is still inefficient, with an inadequate qualification structure for public servants, poor equipment and outdated working methods. The new Law on Public Administration introduces its modernization.

## **Local Finances**

Traditionally, the Serbian municipalities used to have their own property, but it was taken away from them and transferred to the state following the Property Law of 1995. This act has seriously jeopardized the position of the municipality as a legal and economic entity.

Legal regulation of municipal property is linked to the passing of a set of laws that should solve some open questions (restoration of dispossessed property to private persons and public entities, registration into cadastral registries, and so on), but any further postponement would leave municipalities dependent on the central government and would interfere with the very essence of reforms. Nevertheless, the new laws have helped the course of reform in several ways. The municipalities have been given several new taxes, a portion of tax funds has been redistributed in favour of the local governments, and the municipalities have been given an opportunity to raise loans, which has resulted in an almost doubling of local self-government revenues in the period 2001-2002.

Some 35% of the total municipal revenues originate from resources partly or totally controlled by local government, which represents a considerable share, compared to other countries in the region. However, in order to create a more efficient system of local government financing, existing local government revenues need further strengthening.

One of the major problems is that the system of local government financing is to a large extent based on part of the sales tax (30% comes from this source), because Serbia is obliged soon to substitute this tax with the Value Added Tax (VAT), in accordance with EU standards. Upon the introduction of this tax, the system of local government financing will have to undergo radical changes, because VAT cannot be allocated according to the place of collection (as was the case with sales tax).

Further steps towards reform would imply the restoration and protection of local government property, and a greater financial autonomy of local government with the right to establish tax rates. That would secure an opportunity to the local governments, by creating an attractive tax environment and providing services of a better quality, to attract capital and investment to their territories, and thus to encourage economic growth as one of the ways of resolving the problem of poverty. Another part of the reforms would mean the establishment and strengthening of the partnership between the central and local governments in the distribution of goods and financial resources, which is indirectly a part of efforts to establish a developmental model of decentralized market re-distribution.

## **Direct Democracy and Participation of Citizens**

Regarding the immediate democratic institutions, the Law provides for a civic initiative, a citizens' open meeting and a referendum. However, in reality, the level of citizens' participation is very low: they have no information about most important municipal affairs, local authorities do not see citizens' participation as a prerequisite for successful work, there

is no transparency, and the scope for citizens' influence is too limited, which leads to great apathy and passivity.

#### **3.2.4.2 Problems and Constraints**

Due to the lack of a strategic approach at the macro level, a consistent strategy for poverty reduction does not exist at the municipal level either. The majority of municipalities have so far performed such jobs just mechanically as assignments transferred by the State, and without a greater involvement in developing strategic plans, or towards creating and implementing new projects and programmes. In practice, the municipalities have reacted only from time to time and temporarily in assisting the most urgent and difficult cases. Such a state of affairs has primarily resulted from poor economic capacities which do not allow effective and efficient resolution of the problem, but also from insufficient democratic awareness, institutional weaknesses etc.

#### **The Role of the Self-Government in priority sectors of the PRSP**

The municipal assembly is only to take over the role of leader and to initiate strategic, developmental, intersectoral work with other actors in the municipality, in several sectors: education, health care, the private sector, employers, labour unions, social welfare centres, labour market, Refugee Commissariat, NGOs etc. For the purpose of institutionalising sustainable strategic and intersectoral work more and more municipalities will establish socio-economic councils.

Social welfare and social assistance. The most significant implementers of social protection activities in municipalities are local governmental bodies, Social Welfare Centres, a certain number of social institutions, and the numerous humanitarian and non-governmental organisations.

A Social Welfare Centre is a municipal authority specifically established for the purpose of carrying out such assignments, and it is the main carrier and implementing agent of social policy at the municipal level. In the municipality, there is a number of typical humanitarian organizations (the Red Cross and others) and NGOs, which perform that type of activities. The Commissariat for Refugees and the Employment Bureau also collect some data, and carry out analyses that may be relevant in dealing with problems of poverty.

Education. Primary education falls within the new competences of local governments (provision of infrastructure and buildings, as well as foundation rights), for which local governments must prepare themselves. The new Law on Primary Education will specify the distribution of the competences and financing between the state and the local governments.

The most important stakeholders in the sphere of education are the municipal authorities (Assembly, executives bodies and the Secretariat for Education), as well as schools, professional educational organizations and NGOs dealing with educational issues. Users of services (students and parents) have an important place in the reform of the education

system. It is thought that the introduction of a per capita financing system for schools would raise the quality of their work.

The new laws create the possibility for alternative school programmes.

Health Care. Primary health care is included in the new competences of local governments (provision of infrastructure and buildings), which entails allocation of funds for carrying out such activities. The current status is slightly improved, but only *the new laws* in this area will provide for a more specific distribution of competences among various levels of government, as well as the manner of financing (see chapter “Health Care Towards Poverty Reduction”).

Housing and Urban Development Planning. A substantial part of the municipalities in Serbia suffer from chaos in both urban and architectural planning, with non-registered buildings and a lack of planning. There is no accurate data on subtenants and a substantial number of citizens live in inadequate flats (in respect of both conditions and size). See chapter “Regional, Rural, Urban and Housing Aspects of Poverty”.

Local governments have certain operational advantages in identifying both problems and realistic objectives, and creating adequate housing programmes together with citizens. In the area of urban planning, the city urban planner could play a useful role in preventing illegal construction and introducing standards in developing the urban areas.

### **Functional Relationships**

The relationship between the municipal and Republic authorities is satisfactory, but the information exchange from the Republic level to the local one is insufficiently effective and is inefficient. The practice of delivering information through political parties’ channels has not ended and the problem of symbiosis of the state and party (through their bureaucracies) should be raised as one of the obstacles to the implementation of reform processes and modernization.

The relationships between municipal authorities, services and organizations in this area are correct, but there is an evident problem of poor functional links among the actual and potential stakeholders. Furthermore, these relationships are burdened with all the weaknesses of the neglected local governments, such as offices poorly equipped for information technology,, a discrepancy between the municipal by-laws and legislation, inadequate skills among the staff, outdated knowledge, a primary focus on political and party issues, too large an influence of individuals and informal lobbies on the decision-making process, poor monitoring of the implementation of projects and activities, as well as the slow implementation of decisions, levelling of remuneration and generally low salaries of staff, poor transparency of work, and a culture of exclusiveness and quite a low participation of citizens. The practice of measuring the efficiency of the work of municipal authorities has not been established at all, so introducing qualitative and quantitative indicators would contribute to improving the quality of work in that area.

## **The Resources, Human Resources and Equipment**

The salaries, various services, equipment, and capital investments in buildings are financed out of the municipal budget, but the lack of financial resources needed for major projects is obvious.

The municipalities lack key experts, those who would deal with the strategy and the development, planning, decision making, organisation, coordinating and controlling of activities. Knowledge and skills are required in order to secure the municipality's own income (private public partnerships), to create an environment attractive for investments (entrepreneurship, marketing and information sharing), and to include in the development all potentials of the citizens. The training of new personnel (city managers) is of exceptional importance. The existing personnel also require a comprehensive and continuing education in order to understand the nature of social phenomena and the interconnection of the problems to be resolved. Through this training they would be able to develop a greater creativity in their work.

In most cases, municipalities have at their disposal very modest technological equipment, the purchase of which is provided for out of the municipal budget, and all of them lack the means to create a network for a single information system.

## **The Participation of Citizens and the Local Community**

Despite the recent changes and the fact that the current law foresees citizens' participation in governance and decision-making processes, this is rarely implemented in practice. In the course of the previous 15 years, the autocratic regime caused all the democratic mechanisms of government to deteriorate substantially. Municipal officials and municipal administrations have not yet developed ways of increasing and improving the quality of citizens' participation. Members of local assemblies and municipal authorities need to be educated on the ways to improve the dissemination of information and achieve higher transparency in their work. At the local elections votes are still predominantly given to political parties and less in response to the effects of the work of officials and their successes.

On the other hand, citizens rarely consider the municipality as a place and a mechanism whereby they could resolve their (in fact, general) problems. Consequently, citizens and municipal authorities remain distant and opposing parties, with separate needs and interests.

It is encouraging that in the majority of municipalities, the authorities have established good cooperation with non-governmental organizations by assisting them both financially and logistically in the implementation of various projects for poverty reduction or prevention, recognising in such projects both common and general interest.

### **3.3. Global and Regional Integration**

#### ***3.3.1. European Integration***

In addition to a greater degree of democratization, the European integration process represents a key factor for securing stabilization in Serbia. Stability is a precondition for the increase in foreign investment and domestic savings, which are also the preconditions for economic development. The inclusion of Serbia in European institutions in the next decades will be a crucial step for further social, economic and political development.

##### ***3.3.1.1. The Stabilization and Association Process***

The European Commission for the so-called countries of the western Balkans (Albania, Bosnia and Herzegovina, FYR Macedonia, Croatia and Serbia and Montenegro) which are not in the first or the second group of countries to become full members of the EU, has created a stabilization and association process (SAP). This process should gradually prepare these countries for membership of the EU, and should give their governments political encouragement to cooperate with the Commission/Union. In other words, for Serbia and Montenegro (and others as well) the Stabilization and Association process is a first step towards full membership of the EU.

In Serbia and Montenegro, this process has begun with the establishment of a Consultative Task Force FRY-EU which, through a series of meetings in 2001 and 2002 and other activities on preparing the Stabilization and Association Agreement, enabled information exchange, adjustments of local policies and reform of local institutions. One of the results is the establishment of the Office for European Integration at the federal level, i.e. at the level of the state union, in 2001. Now a feasibility study is to be prepared. This study will provide an evaluation of the readiness of the country to begin negotiations in 2004 on the policies that will be part of the Stabilization and Association Agreement. The parts of the agreement on foreign trade liberalization and on opening EU market for the domestic products export are of greatest importance for economic growth and overcoming poverty.

The commencement of work on the Feasibility Study is conditional upon the adoption of the Action Plan for the harmonization of economic systems, i.e. foreign trade policies and regimes between Serbia and Montenegro, which practically boils down to the defining of an Action plan for the creation of a customs union.

The CARDS programme, led by the European Agency for Reconstruction, which encourages reform and transition, is also a part of the process of integration into the EU. Generally speaking, such help creates preconditions for economic growth, and improves it as a tool for overcoming poverty. The CARDS programme itself does not deal directly with poverty or its eradication, i.e. with some specific vulnerable groups, but as the reconstruction requirements decrease, the CARDS funds are progressively used for sustainable economic development.

The focus of the CARDS programme is on building institutions, strengthening administrative capacities, the judiciary and internal affairs, which will basically help create a credible business environment and thus encourage further investment and so have an indirect favourable effect on the suppression of poverty, either through the stimulation of economic growth and job creation or through increasing real revenue of the country and real budgetary funds for the fight against poverty. The European Commission and the member states also provide macro-financial assistance (MFA) in grants and loans for direct budgetary support. This help has the same effects on poverty as World Bank budgetary support by loans for structural adjustment. The first MFA instalment included an amount for payment of arrears to the European Investment Bank.

European integration plays an important role in the successful implementation of the Poverty Reduction Strategy. In the first place, the Stability Pact for South-East Europe will significantly help the process of the return of refugees, which will have a direct positive impact in one difficult area of the poverty issue in Serbia.

Secondly, the European Union in Copenhagen in 2002 and in Brussels in 2003 affirmed “the European perspective” of the West Balkan States, which opened the way for Serbia and Montenegro to take part in the programmes of the Community, especially in the areas of education, professional training and the so-called “twinning” programmes for the transfer of administrative capacities into the European Community. This would directly contribute to the achievement of Strategy objectives, partly through direct financial support for the education system and partly through creating a recognizable European business environment playing a key role both in attracting strategically important investors and in improving the level of security for small enterprises – two cornerstones on which the economic growth of newly accepted members of the European Community rests. To that end, it would be advisable for the creators of the economic policy of Serbia and Montenegro to adopt the principles of the European Charter on small business enterprises, to which we are obliged as signatories of the Solun Declaration.

Thirdly, through direct asymmetric preferential trade arrangements, the European Union directly supports Serbia’s accession to EU market, and thus, indirectly supports employment; it carries out non-inflationary expansionary measures of economic policy towards the Serbian economy.

Fourth, it has been agreed, within the SAA, that cooperation with the West Balkan countries will follow the “step-by-step” principle which means that Serbia and Montenegro have a strong incentive to approach the European Union at the rate at which they are able to bring their regulations into line with the relevant principles and regulations of the EU, in order to further economic growth and indirectly aid the success of the Poverty Reduction Strategy.

Fifth, it should be borne in mind that in the Amsterdam Treaty ratified in Lisbon in March 2000, the Council of Europe came to the conclusion that the level of poverty and social exclusion in the EU itself is too high and that a determined effort must be made towards its eradication by the year 2010. The measures proposed for the implementation of the

European Strategy are completely compatible with the measures adopted in the Poverty Reduction Strategy in Serbia.

### *3.3.1.2. Harmonisation of Economic Policies with Montenegro in the light of the Stabilization and Association Process*

Future development of the international integration of Serbia and Montenegro crucially depends on harmonisation of their economic systems and economic policies. After the changes in October 2000, the international economic integration of FR Yugoslavia was not significantly disturbed by the existence of two economic systems, two monetary areas and two customs (foreign trade) areas. But since the new state union of Serbia and Montenegro has been formed, under the patronage of the European Commission, i.e. European Union, it is expected that there should be harmonisation of economic policies. This means that there should be a customs union and the adjustment of certain indirect taxes, especially excise tax. Two main directions of international integration: membership in the World Trade Organization (WTO) and the Stabilization and Association Agreement (SAA), depend on how fast the customs union, i.e. the common market of Serbia and Montenegro, materialises.

At the beginning of June 2003 the Action Plan for the harmonization of the economic policies of member states was adopted to eliminate obstacles to the free flow of people, goods, services and capital. According to the Action Plan, the republics reached a compromise by which Serbia would lower its customs rates, not at once but over the next 18 to 24 months and Montenegro would go on using non-tariff barriers; the foreign trade systems will be brought into line in the following 18 to 24 months. Meanwhile there will be two customs areas and two customs administrations. In addition, duty rates in Serbia will be reduced from 9.4% to 7.1%; the foreign trade system rests exclusively on tariff protection; there are virtually no non-tariff barriers and tariff rates are relatively high. On the other hand, Montenegro has substantial non-tariff protection; relatively low duty rates, but numerous non-tariff barriers (quotas and licences) which are not transparent and which will not be abolished by the Action Plan. The tariffisation of these barriers has not yet taken place, but according to some preliminary estimates, effective protection was lowered from over 20% to below 10%. As for the foreign trade regime, the member states will submit proposals on the Law on Foreign Trade by December 31 at the latest. As they are to be based on the regulations and practices of WTO, harmonization of these documents should not, in principle, pose a problem. The effects of harmonization on poverty should be viewed from the perspective of further liberalization of foreign trade, joining the World Trade Organization and the process of stabilization and greater integration with the EU.

### *3.3.2. International Financial Institutions*

After the political changes of October 2000, Serbia and Montenegro restored its membership in international financial institutions (the International Monetary Fund, the World Bank, the European Bank for Reconstruction and Development, while membership of the European Investment Bank is related to European Union membership).

## **The International Monetary Fund (IMF)**

The membership of Serbia and Montenegro in the IMF was restored in December 2000, while the first Stand-by agreement was concluded in June 2001. At the moment an EFF (Extended Fund Facility) agreement is being conducted. Though the basic IMF role is to give support to the national currency by giving loans as a way of supporting the balance of payments of a country, the significance of the agreement with the IMF is far greater. These agreements are the preconditions for the macroeconomic stability of a country, and what is more important, they are the guarantee that this stability will be maintained. Because of the positive effects that macroeconomic stability has on poverty reduction, membership in the IMF, i.e. an efficient implementation of an appropriate IMF agreement, is a precondition for the reduction.

One of the preconditions for concluding any of the agreements with the IMF is a balanced budget, that is, the curbing of the fiscal deficit, which may limit the possibilities for income redistribution towards the poor. Since the basic strategy for overcoming poverty is the acceleration of economic growth and macroeconomic stability and not income redistribution, the agreement with the IMF is crucial, as it accelerates economic growth.

In the field of relations with the IMF nothing new is expected except the continuation of the implementation of the EFF agreement which will last until March 2005.

## **The World Bank**

Serbia's membership of the World Bank was restored in May 2001. At the same time, a three-year Transition Support Strategy (TSS) was harmonized and Serbia was admitted to the IDA (International Development Agency). This means that the credits provided by the World Bank will be under concession conditions (with respect to interest, grace period of the credit and terms of payment), which are better than market ones. It was anticipated that Serbia will receive 540 million USD, under TSS, 80% of which will be in the form of structural adjustment credits (SAC). This programme represents direct budgetary support linked to the implementation of planned reforms.

By means of this budgetary support, the budget balance will be maintained and macroeconomic preconditions for accelerated economic growth and consequently, poverty reduction, will be created. This creates preconditions for an increase in the available resources and for increasing the transfer to the poorest, which directly decreases poverty.

TSS expires in the first half of 2004 and will be substituted by the Country Assistance Strategy (CAS). There is a question whether Serbia will be allowed to keep IDA status or whether this status will be changed to IBRD (International Bank of Reconstruction and Development) status under the new CAS. Since IDA credits are granted under more favourable conditions than IBRD loans, it is important to try to keep the present status. The status will be negotiated with the World Bank taking account of the social, economic and political situation.

### **The European Bank for Reconstruction and Development (EBRD)**

Serbia has been a member of the EBRD since January 2001. Recent EBRD activities in Serbia were directed towards creating a business environment suitable for development of the private sector, i.e. creating economic growth. These activities therefore had only indirect effects on poverty. Some direct effects came from investments in infrastructure, especially in utilities, which provided improvements in the basic infrastructure services for the poor.

### **The European Investment Bank (EIB)**

The commencement of cooperation between the European Investment Bank (EIB) and Serbia and Montenegro, has been marked with loans for the rehabilitation of large infrastructure facilities, which have improved the general business environment and provided opportunities for future job creation, but without any direct effect on poverty reduction.

### **3.3.3 Membership of the World Trade Organization**

Membership of the WTO should be considered in the framework of further foreign trade liberalisation and its beneficial effects on poverty, either through the growth of real incomes of all consumers in one country, through encouraging economic growth without any changes in income distribution, or through decreases in the prices of certain products.

Apart from that, membership of the WTO brings most favoured nation status (MFN). This will increase export demands and beneficially affect economic growth. The most important benefit is that the WTO provides the most favourable transition framework.

Finally, membership in the WTO will lead to the conclusion and implementation of agreements on free trade zones, which are important for effective foreign trade liberalisation. These agreements have to be conducted according to WTO regulations. Though the obligation related to these agreements originated from the Stability Pact and not from membership of the WTO, members are obliged to remove any hidden barriers in such agreements.

### **III STRATEGIC DIRECTIONS OF THE REDUCTION OF POVERTY IN SERBIA**

The reduction of poverty in Serbia depends on the capability of achieving sufficiently high levels of sustainable economic growth, together with an effort to prevent inequalities in the distribution of the national revenue from deepening. Achieving social and economic stability is a precondition for the attainment of this objective. In such a context, the continuation of the process of democratisation as well as the process of European integration, along with maintaining the level of macroeconomic stability which has been achieved are key elements for increasing economic activity and employment, the growth of salaries and the reduction of poverty.

#### **1. Improved Employment Opportunities**

The unemployed faced not only the greatest risk of poverty but also the most severe and deepest levels of poverty compared to other actors in the labour market. The proportion of unemployed individuals in a household considerably reduces consumption and increases the risk of poverty.<sup>68</sup>

##### **1.1 Creation of new employment opportunities**

The main objective of the economic reforms in Serbia is the creation of a modern, export-oriented market economy dependent on the private sector and capable of achieving dynamic economic growth and job creation. In such an economy, new employment opportunities as well as opportunities for economic growth will result from increased internal and external demand with the improved competitiveness of Serbian companies and more efficient use of available resources.

To be successful in this task the economy needs a clear ownership structure, strong corporate governance, and better management. In this context the ongoing comprehensive reform of economic legislation and the efficient privatisation process are critical (see Annex for more information on the comprehensive legislative reform currently being undertaken in Serbia).

Through FDI, private investments, the development of an entrepreneurial spirit and the SME sector, it is the objective of the government to increase the share of private ownership in the economy from 42.5 percent in 2002 to 75 percent in 2005. This will result in a dramatic increase in the overall share of workers employed in the private sector where the average salary is higher.

Increased domestic and foreign demand is a mechanism for increasing economic activity and creating new employment opportunities.

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<sup>68</sup> For more on this methodology see in Krstic, G: The Determinants of the Consumption of the Poor, Poverty in Serbia in 2002, The Ministry of Social Affairs, 2003

## Increased internal demand

Increased internal demand will result from a combination of the following factors:

- increased employment and investment rates through an FDI driven privatisation process;
- increased employment and investments as a result of foreign direct Greenfield investments;
- increased purchasing power and domestic savings;
- increased public investments.

So far the privatisation process has resulted in **increased investments in privatised companies** at the pledged amount of EUR 567 million. The objective of the privatisation process is to sell up to 70 percent of state and socially owned companies via transparent auctions and tenders. By September 2003, out of 1074 companies offered for privatisation, 843 had been sold. In addition to the above-mentioned investments, this has resulted in a million euros of total privatisation revenue and 253 million EUR for social programmes (severance payment and retraining). A large proportion of the privatisation revenue has come in the form of FDI.

There is also an increase in Greenfield investment. Serbia is rapidly establishing a liberal investment regime. Although structural barriers still persist, the Government endeavours to remove impediments, reform business activity and open the economy to foreign participation.

FDI investments through privatisation and Greenfield investments have a **multiplier effect**. Demand for local goods and services will increase due to the actual investments and the need for inputs to the production process. In addition the employment of staff will result in increased personal consumption and investments.

The **increase in purchasing power** is linked to a real increase in salaries. The Serbian average monthly net salary increased to USD 151 in 2002 from USD 90 in 2001 and USD 45 in 2000. As of May 2003, the monthly net salary has further increased to EUR 170.<sup>69</sup>

As the average salary is higher in the private sector than in public and state owned companies, this trend is expected to continue with the continuation of the reforms towards a market economy based on private capital. The increase in purchasing power is expected to result in an increase in domestic savings.

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<sup>69</sup> The Republican Statistics Bureau and NBS

**Public investment** is expected to rise in the forthcoming period. This will be accomplished through the improvement of the management of public expenditures with the aim of redirecting budgetary funds which are now used for public spending into investment.

### **Increased external demand**

Increased external demand will mainly be driven by the following elements:

- liberalization of foreign trade
- increase in exports
- strategic position
- free trade agreements
- WTO and European Integration

### **Liberalization of Trade and Free Trade Agreements**

Although liberalization of foreign trade in the short term will have a negative effect on existing employment it will have a positive effect on employment in the medium to long term. Liberalization stimulates restructuring, so that companies that are not in a position to withstand the pressures of competition must either adjust or close down. This opens up the economy for the development of new and profitable enterprises which will create new employment opportunities and higher wages.

### **Increase in exports**

Serbia's integration into the international economic processes and the improvement in exports represents a prerequisite of its development, since it is a small country and therefore bound to have large-scale economic trade with the surrounding countries. Hence the increase in exports will be one of the main generators of economic growth.

### **Strategic position**

It is the objective of Serbia to become the major trading and market centre in South East Europe. It is strategically located within Central East Europe and borders new member states. Serbia is the natural gateway between South East, Western, and Central Europe, positioned at the intersection of Pan European corridors no. 10 and no. 7, on the banks of the Danube, one of the biggest and most important river routes. Together with a well-developed transportation network, this makes Serbia easily accessible.

## **Free Trade Agreements**

Serbia is in the middle of the South East Europe Free Trade Area that enables duty-free access to a market of 60 million people in Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Former Yugoslav Republic of Macedonia, Moldova and Romania. The diversity of the eight countries in the area, in terms of their position, legal environment, growth potential, resources and prices, offers a great opportunity for companies and investors to improve their business performance through regional cooperation. A draft free trade agreement was signed in 2001.

The main points of the agreement are as follows:

- Liberalization of at least 90% of mutual trade by the end of 2008;
- An appropriate common set of preferential rules;
- WTO-consistent provisions for the application of anti-dumping, countervailing, safeguard measures and intellectual property protection;
- Transparent and non-discriminatory measures concerning public procurement, state aid and state monopolies;
- Harmonization of trade legislation with that of the EU (especially customs procedures, competition law, company law, company accounts and taxes and banking law).

Serbia and Montenegro is also the only country outside the Commonwealth of Independent States (CIS) that has a Free Trade Agreement with the Russian Federation allowing it access to the market of 150 million people.

In the preceding chapter we discussed European integration and joining the WTO.

Increased Competitiveness as a mechanism for creating new employment opportunities

The National Competitiveness Strategy, the preparation of which is drawing to a close, sets the following priorities:

- improving the productivity of the private sector, emphasising improvements in quality and added value rather than price-based competition;
- integration into the international business community so that Serbian companies can develop their business markets and strategic partnerships;

- building industry clusters in high priority sectors to improve the productivity of the sector and the enterprises, including research and development, human resources and capital markets;
- improving companies' access to and productive deployment of financing;
- attracting strategic foreign investors whose financial and intellectual capital can rapidly accelerate the restructuring of individual firms or provide the foundation for the development of new exporting clusters;
- actively searching for investors willing to make substantial, long-term investments in plant improvement, worker retraining, and research and development;
- increasing the capabilities for using existing technologies and innovations to create new competitive advantages;
- improving market and business skills.

“The comparative advantage of Serbia is reflected in its educated workforce, low wages, functioning infrastructure, cheap overheads, strategic position in the centre of the Balkans, as well as the potential for expanding to other Balkan countries through Serbia.” (The National Competitiveness Strategy).

### **Increased investments as a mechanism for creating new employment opportunities**

A significant determinant of the speed of medium-term growth and thereby the creation of new employment is the share of investment in GDP. From a very low level of 14% a significant increase is expected to a level of 25% as in comparable transition economies. The increase in investment share should mainly be achieved through increasing domestic savings from the current minimal level of 2% of GDP to 17% of GDP.

Improved utilisation of capacities together with a relatively low capital coefficient during the first years of the medium-term period should provide the projected growth rate and the increase in employment opportunities with lower investment rates.

In the 1990s production in Serbia was more than halved, which brought about a proportional fall in the use of capacity. Naturally, some of the capacity meanwhile became obsolete, but the infrastructure remained. Therefore only moderate investment is necessary to boost economic activity.

The aim of introducing tax incentives is to create a highly favourable tax system, encouraging investment, accelerating the development of underdeveloped regions and facilitating employment opportunities. Corporate profit tax is the lowest in the region at 14 percent. Incentives include ten-year tax holidays for investments in fixed assets over 100

million EUR and creating more than 100 work places. Investment in regions of special interest to Serbia is encouraged through a five-year tax holiday. There will be special tax benefits for investments of over 100 000EUR and the permanent employment of at least five workers. Moreover, VAT will replace sales tax in 2004.

### **Domestic savings and the banking sector**

The increase in domestic savings mentioned above will contribute to the development of a healthy banking sector. The first step in the restructuring of the banking sector was a necessary but difficult pruning of insolvent domestic banks. This resulted in the closure of 23 banks out of 98, including the largest four. During the same period a certain number of foreign banks have established themselves and foreign interest is still high. The next step is for the state to privatise nine banks in which it is a majority shareholder, as well as to sell minor holdings in seven other banks. The plan is that most of these banks should be sold to strategic foreign investors, leaving at least two strong domestic banks. This should all contribute to the creation of a healthy and competitive banking system.

Along with the privatisation of banks, it is envisaged that the supervision of the banking system will be strengthened through the adoption of the supervision development plan as well as through the establishment of a supervisory council. As for legal regulations, a law has been adopted requiring the use of international accounting and auditing standards. It is intended to provide necessary preconditions for a reliable banking system which would attract domestic savings and secure their rational use.

The development of the existing institutions (insurance and similar) and the establishment of new ones (voluntary pension funds etc) will open up new opportunities for collecting and augmenting domestic savings. This, together with the banking system, should mobilise the existing and future savings of the population, the sector which is traditionally a net saver. Total saving deposits within the Serbian banking sector have increased several times from a very low level in 2001 to over 1 000 million USD at the beginning of 2003. For the most part domestic savings will be invested in small and medium-sized enterprises which should be, together with foreign direct investment, the main generators of growth.

### **Public investments**

Even though only a small part of overall investments, public investments are important for medium-term growth. In addition to their direct impact on growth, they also have an indirect effect through the creation of a favourable environment for investment and growth. The share of capital expenditure within the budget of Serbia is low. Therefore, above average growth is planned for in the medium term. There should be a relative increase from 2% to 4% of GDP to reach a level meeting international standards.

It is estimated that around one third of the overall investment<sup>70</sup> in Serbia in the period 2004-2006 will be directed into infrastructure (transport, energy, telecommunications, the postal service, utility infrastructure). These investments will be financed from:

- Resources of the enterprises in the above mentioned sectors (their own resources and commercial loans),
- Budgetary resources (republican and local budgets), and
- Expected donations and soft loans.

*So far more than 1 billion EUR in concessionary loans have been directed into infrastructure: 449 million EUR to transport including 220 million EUR to the road, 127 million EUR to the railway and 127 million EUR to the aviation sectors; 346 million EUR to the energy sector and; 217 million EUR to local level infrastructure (water, central heating and local transport). In addition, around 95 million EUR in concessionary loans have been agreed for investments in the health and education sectors*

Investments will support the creation of a revitalised and reliable power sector which aims to become an important electricity exporter in a region with an overall deficit of energy. Currently a new energy law is being drafted which will provide for harmonisation with the EU and fast liberalisation. The creation of joint venture and concession enterprises is encouraged. Potential areas are the development of pipelines, gas storage facilities, and the modernisation of thermal and hydro electro power plants.

As regulatory and market reforms gather speed with the aim of building a modern telecommunications system that will meet the growing needs of a customer-based market economy, the level of investment is expected to increase. By 2005 it is expected that a fully digital network will be established.

It is estimated that the entire necessary resources for investing in telecommunications and the postal service will be provided from commercial sources (domestic and borrowed). Modernization and construction in other infrastructure activities will to a great extent depend on budgetary resources, donor funding and soft loans.

Investments by the state, domestic enterprises, and foreign investors in infrastructure will have direct and indirect impacts on the level of economic activity, employment and poverty reduction. Direct impacts will include GDP growth and higher employment. Multiple effects of infrastructure investment on economic activity result from the fact that in the building of infrastructure mainly domestic raw materials are used. Also, investments in housing and certain infrastructure investments are labour-intensive, which stimulates employment, particularly of the semi-skilled (poorer) labour force. An additional significant contribution

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<sup>70</sup> The share of infrastructure in GDP is relatively high due to its deteriorated state and the fact that these are actually capital intensive sectors.

to poverty reduction is increased accessibility and quality of services in infrastructure activities.

Construction of infrastructure contributes to reductions in costs and increased efficiency of economic activities in a particular location. Modern infrastructure stimulates commercial investments into the industry and service sectors. Implementation of these investments leads to the improvement of the overall level of development of certain areas which, in turn immediately alleviates poverty. In this context it can be said that investments in infrastructure represent one of the generators of economic activity and employment and therefore of poverty reduction as well.

All these investments will not only contribute to employment during the transitional period but also to laying the foundation for the future.

### **Foreign direct investments**

It is clear that there are still significant obstacles to the entry of new enterprises. These obstacles concern high political and regulatory risks. While significant improvements have been made, substantial legislative and institutional reform is still required. The most important part of this reform is linked to the reform of the legislative and justice system, since uncertainty in this area, including slow enforcement of court decisions, is one of the most important sources of risk for investors.

Serbia has enacted specific legislation outlining guarantees and safeguards for foreign investors. The former Federal Law on Foreign Investment (January 2002) has been formally incorporated into Serbian law (2003) and establishes the legal framework for investment in the Republic. The law eliminates previous investment restrictions; extends national treatment to foreign investors; allows for the transfer/repatriation of profits and dividends; provides guarantees against expropriation; and allows for customs duty waivers for equipment imported as capital-in-kind. In late 2002, the Government of Serbia promulgated new tax incentives for foreign investors.

Since foreign capital is vital to the restructuring of the real sector it is of vital importance to remove barriers and stimulate investor interest. Thus, reform efforts have not been limited to the promulgation of the two foreign investment laws. Rather, the government has understood the need to make reforms to a wide body of laws that will improve the overall business regulatory environment and enable private sector companies to grow and to compete.

Sustainable mid-term macroeconomic stability is another factor that should attract foreign direct investment. It has already been stated that inflation has been brought down to a very low level together with extensive liberalization of prices, that the Dinar was made convertible, foreign trade liberalized, and so on.

Although total FDI levels are still negligible compared to elsewhere in the region, Serbia could easily overtake other countries in Southeast Europe.

#### **Total level of Level of FDI (million USD)**

<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
60	160	550	1.000	1.300	1.600

FDI numbers for 2003, 2004 and 2005 are rough projections

*A stimulating investment environment is based on implementation of the so called «12 commandments»: a stable and predictable macroeconomic policy; an effective and honest (incorrupt) government; a large and growing market; freedom of activities in the market; minimum government control; reliable infrastructure; availability of high-quality factors of production; a strong currency; possibility to pay up profits, dividends and interest rates; a stimulating taxation climate; freedom to do business between the markets*

#### **Privatisation and investments**

The direct effect of privatisation is an initial drop in employment in newly privatised enterprises. However, privatisation also creates preconditions for new, sound private investments. Such investments will lead to the creation of new jobs, though this will take some time. Over time it is to be expected that privatised enterprises will create significant new employment opportunities.

The Law on Privatisation, adopted in 2001, met with general approval as the best law on privatisation in all the former socialist states and has already won a considerable amount of trust concerning the privatisation process.

The sale of large socially owned enterprises is expected to be completed by the end of 2006. The privatisation of large public companies is expected to begin in 2005 depending on the completion of reconstruction, the adoption of relevant regulations and the establishment of regulatory institutions. The work on the draft legislation and setting up the institutions is under way.

Privatisation of small and medium-sized socially-owned enterprises through auction is a precondition for accelerated growth within the SME sector. It is expected that around 800 enterprises will be privatised in this way in 2003 and that in 2004 privatisation of almost all small and medium-sized enterprises will be completed.

During the coming period the state will sell its minority shares in companies that started the process of privatisation under the old regulations and thereby complete the privatisation of these enterprises.

The Ministry of Economy and Privatisation together with the Agency for Privatisation mostly carry out the comprehensive government plan concerning privatisation as well as working on strengthening capacities for this complex task.

## **Greenfield investments**

The experience with transition in Eastern Europe has shown that foreign direct “green field” investments and new direct private investments by domestic investors are the basic vehicle for accelerated economic growth and the creation of new employment.

New enterprises are not under the pressure of the past. They do not have inherited debts, and are organised to maximise profits and economic efficiency. Without these new investments, even the privatisation of existing enterprises cannot provide the projected economic growth and creation of new jobs.

*The largest Greenfield investment so far is Ball Packaging which has made a commitment to invest 75 million EUR . Merkator, with an investment of 38 million EUR and plans for further investments in other cities than Belgrade are the largest investor in the retail sector. So far, it has created more than 400 new jobs. Tetra Pack with the investment of 30 million EUR is among the most successful Greenfield investments. The workforce efficiency in this enterprise is high in a European context and they export to Bosnia and Herzegovina, Macedonia, Greece and Germany.*

So far the number of newly created enterprises has been smaller than expected. The Ministry of International Economic Relations endeavours to provide the necessary conditions for improvement in the area through an accelerated effort for the development of the investment environment as well as the development of the strategy for the promotion of investment which will be better targeted, based on active measures and simultaneously continuing the effort to enhance the competitiveness of Serbian economy. This will be done in close cooperation with the Ministry of Economy and Privatisation which undertook the task of drawing up the Industrial Strategy for the Republic of Serbia, which, as its essential component, should result in action plans for industrial growth in various sectors, including:

- The development of smaller industrial units.
- The sustainability of medium and large industrial units.
- Promotion of certain industrial sectors.
- The recovery of industrial enterprises with poor business performance.
- The development of entrepreneurship.
- Protecting the environment (promotion of environmentally friendly production).
- Equal employment opportunities.
- Promotion of exports.

## **The SME sector as a mechanism for creating new employment opportunities**

### **SME Strategy**

At the beginning of 2003, the Government of the Republic of Serbia adopted the document entitled “The Strategy of Development of Small and Medium-Sized Enterprises and Entrepreneurship in the Republic of Serbia for 2003 – 2008”. The primary objective of this strategy is to create a framework for the creation of a sustainable, internationally competitive and export-oriented sector of small and medium-sized enterprises and entrepreneurship (hereafter referred to as SME sector) in the forthcoming five-year period.

In this respect, the Government of the Republic of Serbia defined the development of SME sector till the end of 2007 as its main strategic goal with an increase in the overall number of SMEs from around 270,000 (in 2002) to around 400,000. This involves:

- Giving precedence to the sectors capable of significantly increasing employment and stimulating economic development: processing of agricultural products, industrial production, tourism, and electronic business (e-business).
- Strengthening the organized system of support to the SME sector by way of development of the capacities of the institutions of this system at all levels.
- Elimination of legal obstacles for the operation of enterprises and private entrepreneurs by creating a new legal environment that will facilitate and not hamper the development of the SME sector.
- Implementation of the reforms of public services in order to ensure more efficient provision of services and significantly reduce the administrative and bureaucratic obstacles encountered by the SME sector.
- Increasing the competitiveness of the SME sector through programmes for the development of enterprise management and the adoption of systems of quality and innovation.
- Strengthening links between the education system and the scientific and research system and the SME sector.
- Stimulating the sale of products and services of the SME sector in the local market through better links between large enterprises and SME activities, such as subcontracting, by creating conditions for greater participation of the SMEs in public procurement and greater sale of consumer goods from the SME sector.
- Channelling of the grey economy into legal flows.
- Promotion of activities related to assistance in the development of the SME sector by a continuous media campaign.

## **SME Financing**

The lack of financial resources is one of the most serious problems of small and medium-sized enterprises and entrepreneurs in the Republic of Serbia. Establishing an SME Guarantee Fund, with the aim of providing security to creditors for a part of the loans granted to SMEs which have growth potential but are not bankable will mitigate some of this problem. Therefore, it is important to capitalise this Fund as soon as possible, including with funds provided as international assistance.

The private sector remains a dominant source of financial resources for the development of the SME sector. Therefore as mentioned earlier it is critical that the banking reform is completed as soon as possible.

*The creation of a legal framework for the establishment and operation of microfinance institutions would secure greater accessibility of financial resources for poorer citizens and entrepreneurs, by way of microcrediting which allows for more favourable conditions and simpler procedures than bank credits, though the conditions are still strict. In most neighbouring countries, as well as in Montenegro, donors' willingness to provide resources for microfinancing, through NGOs and other institutions besides banks, has led to the creation of legal conditions for these activities. Microfinancing has also been supported through the "Strategy of Development of Small and Medium Enterprises and Entrepreneurship in the Republic of Serbia for 2003-2008".*

During 2003, access to capital for micro-enterprises and self-employment has significantly improved in certain regions in Serbia. There are now three big financial institutions offering micro loans: ProCredit Bank, Opportunity International and Nacionalna Stedionica.

## **Implementation of SME strategy**

In addition to the Ministry of Privatisation and Economy, the Republican Agency for Development of Small and Medium-Sized Enterprises and Entrepreneurship has national responsibility for the implementation of the strategy.

The regional SME agencies and centres will be providers and catalysts of concrete support to owners and managers of small and medium-sized enterprises and to entrepreneurs. It is therefore a priority to extend and strengthen this network as well as the quality and the variety of services provided. By the end of 2002, ten regional agencies and centres were opened in: Belgrade, Kragujevac, Kruševac, Niš, Novi Pazar, Novi Sad, Subotica, Užice, Zaječar, and Zrenjanin.

At the regional and local level, local authorities will have an important role in the stimulation of SME development, assisted by a network of regional agencies, centres, and offices for the development of SMEs providing information and advisory services and training programmes (either directly or indirectly through qualified business consultants) for the SME sector.

## **Legalisation of the grey economy and employment**

The share of the grey economy in Serbia is still very large. The government objective is gradually to integrate the grey economy into the formal sector. This will not be possible unless conditions are created which will discourage the public, enterprises and workers from operating in the informal market. An optimal strategy for the inclusion of the grey economy combines both incentives and penalties.

Wages in the grey economy are considerably higher than in the formal labour market, to some extent owing to tax evasion. The focus should be on the elimination of barriers to business, which have a destimulating effect and which contribute to the spread of the grey economy. Deregulation of economic activities and more transparent institutions will also have a positive effect on the level of corruption. Therefore the fight against the grey economy in many ways starts with the creation of conditions for a more dynamic development of the overall private sector. The introduction of VAT, the lowering of taxes and contributions together with the widening of the tax base and the improvement of public revenue collection and control (and stricter penalties) will reduce the attractiveness of the grey economy and raise operational expenses within this sector.

The development of small and medium-sized enterprises and entrepreneurship, as well as the increase in the economic efficiency of the enterprises, will bring about an increase in wages and the creation of new workplaces in the formal economy. This will also reduce the attractiveness of the grey economy.

In other words, the dynamics of reducing the grey economy will be closely linked to the dynamics of the completion of the transition policies.

## **Agriculture as a source of new employment opportunities**

Agriculture is of the utmost importance for Serbia since it makes up a quarter of GDP (25.1 per cent in 2001). The sustainable growth of the private agricultural sector will play an essential role in the alleviation of rural poverty. The vision of the future status of agriculture is clearly set out in the Law on Agriculture which provides guidelines for the adoption of programmes and policies, sets benchmarks for monitoring progress, and makes it possible for all within the agricultural sector to make long-term plans with a higher level of security.

It also provides a framework for the policy of agricultural support. Some of the relevant objectives are:

**Improving the profitability of the agricultural and food processing industry** will be achieved through applied research and the application of results; through improving the skills of present and future farmers; providing technical and business advice; promoting the exchange of market information.

**Health and environmental protection and achieving the status of a country which provides healthy food** for the needs of the Republic of Serbia in international trade will be achieved through the control of contagious animal diseases as well as diseases transmitted through food consumption; the control of agricultural pests and diseases; and reducing the side effects of pesticide use, veterinary medications and food additives. Full harmonisation with the EU is set as a long-term goal.

**Improving effectiveness and investment in production and processing** will be achieved through the completion of the privatisation of agricultural complexes and processing plants.

**Encouraging optimal and effective use of production resources yielding best economic effects** through the development of market-oriented agriculture and the membership of Serbia in the WTO and the European Union. This demands customs reform as well as various forms of support for agriculture.

**Promoting the optimal use of land** through the rent and sale system, encouraging the establishment of profitable farms. The rational use of water resources will be ensured through the creation of appropriate agencies and mechanisms ensuring effective management of main river systems, flood protection, maintenance of primary and secondary irrigation systems together with the allocation of rights for the use, management and distribution of water to agricultural producers.

**Creating competitive and effective markets for agricultural basic materials and produce**, setting prices in line with quality, establishing producers' marketing organisations, independent product quality assessments, and monitoring monopolistic behaviour in the farm produce markets.

**Protection of arable land, habitats, wildlife reserves and support for the production and sale of organic food.** Protection will be an integral part of agricultural and rural policies. The support for the production of organic food will be capitalised owing to the low level of use of artificial fertilizers in the preceding period. It will also include adequate standards and certification systems.

**Creating conditions for credit support for agricultural producers.** Assistance through reformed agricultural counselling services will be provided through help in drawing up business plans as well as creating conditions for the development of organisations and of microfinancing.

The attainment of these objectives will stimulate employment and economic growth, thus improving social well-being in rural areas (with special emphasise on border and mountainous regions which suffer from emigration).

**Local development strategies as a mechanism for creating new employment opportunities**

The regional differences in the type and structure of unemployment and in competitive advantages suggest the need to find different approaches and policies. Therefore, the overall changes in the economic system aimed at stimulating growth and new jobs should be supplemented by incentives at the local level.

Through local initiatives and measures municipalities can support the development of a conducive environment for the establishment and growth of economic activities, thus increasing the attractiveness of a municipality or a region for domestic and foreign investors.

Hence the Government of Serbia encourages individual municipalities or groups of municipalities to draw up a strategic plan for social, economic, and land development to facilitate business decision-making by potential investors. As of now, the majority of local governments have not developed strategies for the stimulation of employment. It is therefore necessary to draw up development plans on both a municipal and/or an inter-municipal basis that would build upon concepts and policies presented in national strategies and adapt these to local conditions. These planning tools should highlight concrete activities, needs and development goals. Such plans should take into consideration:

- direct investment into infrastructure with the aim of making the region more attractive for potential investors;
- self-promotion (activities whose purpose is not only to inform but also to attract interested investors);
- direct support of economic activities (renting land and facilities along with certain concessions to local and foreign institutions, banks, or insurance companies, setting up of industrial zones, incubator business centres, concessions, exemption from city and municipal taxes, etc.);
- incentives for the development of small and medium-sized enterprises and entrepreneurship.

Without these local level actions plans, the national PRSP employment strategy will most likely fail when it comes to the creation of new employment opportunities. Initiatives for concrete employment programmes should come from the regional and local level. Decentralization supports the identification of innovative and effective policies for a problem where there are no global recipes.

Local governments should also increase their co-operation with the aim of highlighting and building support for reforms and significant projects.

## 1.2. The Development of a More Effective Labour Market

### 1.2.1. Current status and problems

#### Formal Labour Market and Unemployment

The labour market is the main channel through which economic growth influences poverty, because income from work represents the main determinant of living standards.

The formal labour market in Serbia is has the following characteristics: a relatively low level of employment of the population; a high unemployment rate and its trend of continued growth; high hidden unemployment; a low share of employment in the private sector; low wages; and low mobility of the labour force.

Table 1 shows the participation rates and unemployment rates that are defined in two ways: according to the standards of the International Labour Organization (ILO) and according to self declaration of the respondents. The participation rate calculated as the proportion of the active in the total working-age population (men from 15-59 and women from 15-54 years old), according to the definition of ILO, amounts to 62.2% while, according to self declaration, it is somewhat higher and amounts to 65.2%. However, what is particularly important to emphasise is that the unemployment rate, as defined by the ILO, is considerably lower than the unemployment rate according to the statements.

**Table 1. - Participation and Unemployment Rates in Serbia in 2002**

	ILO	Self-declared
Participation rate	62.2%	65.2%
Unemployment rate	8.4%	23.3%

**Note:** ILO – International Labour Organization; the unemployment rate was calculated for men from 15 to 59 years of age and for women from 15 to 54 years of age.

**Source:** Survey on the Living Standard of the Population (SLSP) 2002

Where is the difference? The difference is in that that the ILO definition, which provides for international comparability, starts from the assumption that unemployed persons are those who did not work in the reference period, that they actively searched for a job, and were readily available to start working if someone offered them a job. There were 256 thousand such persons, while those who declared themselves as unemployed, a part of whom worked, were 745 thousand<sup>71</sup>. This means that only a third of the declared number of the unemployed represents the actually unemployed persons. Hence the unemployment rate, according to the ILO definition, which provides for the international comparability and more realistically mirrors the actual state in the labour market, amounted to 8.4%. It is important to mention that this unemployment rate is somewhat lower than the unemployment rate (defined in the same way) calculated using the data from the Survey on the Labour Force (SLF) dated 2002,

<sup>71</sup> This datum on 745 thousand unemployed persons which was estimated on the basis of the Survey is very close to the number of the registered unemployed persons, and there were some 800 thousand of them in May 2002.

which amounted to some 11.9%. Also, according to the official data of the Republic Labour Market Bureau, there are more than 900,000 unemployed on the record, so the unemployment rate exceeds 27%.

The long-term trend of a moderate decline in overall employment and the growth of the unemployment rate from the previous decade also continued in the period 2000-2002. Despite the growth of GDP in real terms, overall employment dropped by 1.6% in 2002 compared to 2000. The decline in the overall employment rate in this period was predominantly due to reduced employment in the social and state sector, since the employment rate has grown in the private sector. Employment in the private sector grew in this period by 21.4%, and its share in overall employment grew from 23.8% in 2000 to 29.4% in 2002. In the same period the earnings of employees have grown in real terms by over 50%.

With regard to the trends and the structure of employment, it is important to point to the relative significance of the non-standard forms of employment, such as temporary employment, and occasional or seasonal employment. The data from SLSP indicate that these forms of employment are not negligible as in the previous period, because they represented 28.9% of overall employment<sup>72</sup>. These forms of employment provide for a higher flexibility in employment and more efficient satisfaction of the demand for work.

Hidden unemployment in government- and socially-owned enterprises, according to some former estimates, amounted to about one third of the employed. High protection of the employed caused inefficient utilisation of human resources, while the employed were protected from competition within their respective enterprises, as well as from competition between the employed and the unemployed. The high costs of dealing with the problem of redundancies of previous policies were borne by the enterprises, which were most often in a very poor financial situation, and therefore they postponed the process of dealing with the issue. Such conditions encouraged the spread of the grey economy among those employees who had full health and social insurance in the formal sector. In the process of structural adjustment, by dismissing those who are redundant, efficiency will be stimulated which will yield growth in the earnings of the actually employed workers, while the hidden unemployed will become really unemployed.

A large number of the unemployed, the those made redundant, as well as a large number of refugees and internally displaced persons, exerted strong pressure on the formal labour

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<sup>72</sup> According to the data from SLSP for 2002, temporary employment and short time employment had a marginal significance in view of the fact that their share in overall employment is only 5%, and 1%, respectively.

market, thus creating a big labour supply as opposed to the low demand for labour<sup>73</sup>. The big discrepancy between the labour supply expressed by the number of unemployed and the demand for labour expressed by the number of vacancies can be understood through the analysis of quantitative and qualitative factors. The quantitative factors can be analysed through the ratio between the unemployed and the vacancies. The number of actually unemployed in 2002 was on average more than seven times as high as the number of vacancies or the demand for labour. The qualitative factor of the discrepancy is reflected in the fact that, despite this large discrepancy between supply and demand, 16.8% of vacancies remained vacant in 2002. The disproportion between the supply and demand for labour is explained by inadequate qualifications among the unemployed, which does not fully correspond to the qualifications required. This unfavourable process of harmonization of the supply and demand was additionally aggravated by the low geographic mobility of the labour force, which is predominantly the result of unfavourable regional development of the economy and an undeveloped property market.

In line with the decline of the overall employment rate in Serbia, there has been a continuous growth of unemployment in the period 2000-2002. The total number of registered unemployed persons in 2002 was 843 thousand, which is 16.8% higher than in 2000. However, based on the data from SLSP, only one third of the declared number of unemployed represents the actually unemployed persons, in view of the fact that a major number of the registered unemployed persons are registered with the Labour Market Bureau because of their entitlement to health insurance (and pecuniary compensation), but they actually work in the informal labour market. For this reason, we shall proceed with the analysis of the characteristics of the actually unemployed persons based on the data from SLSP, and not of those unemployed who declared themselves as such, while they actively participated in the labour market.

The structure of unemployment is very unfavourable. Its most significant characteristics in Serbia in 2002 are:

**Long-term character** of unemployment, because over one third of the unemployed have been looking for a job for more than a year. Such a long-term character of the unemployment in Serbia represents a major economic and social problem which may have deep implications both with regard to the obsolescence of knowledge, and to the rate of use of the available human resources, and in particular to the social repercussions of unemployment.

**Dominant share of the youngest age group** (15-25 years of age) in overall unemployment (40.7%). This age group had an unemployment rate three times as high as the average unemployment rate (25.9% as opposed to 8.4%). This particularly high unemployment rate

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<sup>73</sup> According to UNHCR data, the overall number of the persons displaced from Kosovo and Metohija amounts to around 220,000, whereby about half of them represent a potential growth of the supply of the labour force in the labour market in Serbia.

indicates that young people in Serbia are in a considerably more difficult situation compared to the countries in transition, but it also implies the waste of human resources of those age groups which should give the greatest contribution to the economic and social development of the society.

*It is important to bring to attention another group of the unemployed who are especially at risk – young people. Stimulating economic growth and reducing poverty will also have a side effect of preventing the erosion of the existing labour resources as well as preventing young people from leaving the country. An estimated 300 000 have left the country in the last decade. The aggravating circumstance is the fact that a significant proportion of them are highly educated.*

**A relatively high share of the group having low educational qualifications** (below secondary school qualifications) in overall unemployment. Those unemployed with qualifications below the secondary school level represented 19.2% of the overall number of the unemployed in 2002. Dominant among them are unskilled and semi-skilled workers whose employment will be aggravated in the process of restructuring of the economy and labour force since modern industries require skilled labour. Additionally, the share of the unemployed who had previously been employed amounted to 44% in 2002, and it has been increased due to redundancies.

Compared to the countries in transition, the highest educational qualifications in Serbia, judged by their earnings, are relatively highly valued<sup>74</sup> and considerably higher compared to the countries in transition.<sup>75</sup> The wages of the formally employed with university qualifications compared to the wages of the employed with secondary school qualifications were higher, *ceteris paribus*, by 56.2% in 2002.<sup>76</sup>

On the basis of these results the conclusion may be drawn that investment in human resources, i.e. in education, is one of the ways of escaping poverty, in view of the fact that the labour market rewards higher levels of education.

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<sup>74</sup> The relative ratios between the wages of employees subject to their characteristics will be given on the basis of data from SLSP from 2002 based on Mincer's equation. Monthly earnings of employees in their main job expressed in Dinars are represented as a function of the following variables: gender, age, educational qualifications, location (urban/rural), region, activity, sector of property of the company in which they work and working hours.

<sup>75</sup> See Newell. A. and Reilly B. (1999), Returns to Educational Qualifications in Transitional Economies, Education Economics, Vol.14.

<sup>76</sup> In 2002, on the basis of data from SLSP, this difference in wages of the employees with the highest professional qualifications compared to the wages of the employees with secondary qualifications, provided that the other conditions are unchanged, was somewhat lower and amounted to 51.4%.

## Unemployment by Gender

The rate of unemployment among women was higher than the rate of unemployment among men (9.6% as opposed to 7.5%). Women in Serbia were harder to employ than men, although the educational status of unemployed women was better than of men (8.3% of the unemployed men and 14.8% of the unemployed women have above the secondary education).

Women in employment in 2002 earned less than employed men, *ceteris paribus*, by 24.5%. One part of this difference can be explained by the higher number of hours worked by men compared to women. The results indicate that the estimated differences in the earnings of men and women are among the lowest compared to the other countries in transition.

*Krstic explored wage determination and the evolution of the gender pay gap in Yugoslavia over the period 1995-2000 using the Labour Force Surveys<sup>77</sup>. Men had an average pay advantage over women of 9.3% in hourly measures in 1995 and 9.9% in 2002. However, the gender pay gap adjusted for productivity characteristics between men and women (i.e. education, labour force experience, skill level, etc.), appeared slightly larger relative to the unadjusted measure suggesting that characteristics of employed women are probably slightly better than men's. The ceteris paribus hourly gender pay gap amounted to 11.5% and 16.9% in 1995 and 2002 respectively indicating a significant rise of the ceteris paribus gender pay gap by about one-half. Thus, the slow process of transition to a market economy was not neutral to the wages between males and females. Although the adjusted gender pay differential increased considerably over the observed period, this pay gap is still one of the lowest among transitional countries.*

## Wages: State/Socially Owned Sector Versus the Private Sector

The wages of employees in the private registered sector compared to the social and state sector were higher, *ceteris paribus*, by 29.2% in 2002. This ratio between the wages of the employees in privately owned companies compared to the social and state sector is relatively high compared to the standards of other countries in transition<sup>78</sup> and can be significant for the attraction and keeping of a high-quality labour force in the private sector.

What are the effects of employment in the private sector on poverty? With a higher share of employed persons in a household, who work in a private registered company, it is noticed that their consumption rises compared to employees in the enterprises that are socially or state owned on average by 18%, and the poverty index is reduced. This effect rises if we go from the poorest to the richest section of the population. On the basis of these results, we may conclude that employment in the private sector is one of the ways to increase income and consumption of a household and take it out of poverty.

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<sup>77</sup> Krstic (2002), PhD. Dissertation, An Empirical Analysis of the Formal and Informal Labour Markets in FR Yugoslavia (1995-2000), University of Sussex, Brighton, the World Bank (2003), the Gender Pay Gap in the Transitional Countries, Mimeo, 2003.

<sup>78</sup> See Adamichik and Bedi, 2000, Wage differentials between the public and private sectors: evidence from an economy in transition, *Labour Economics*, 7, 203-224

## **The Grey Economy and the Grey Labour Market**

### Causes of the grey economy

In the ten years of deep economic crisis in Serbia, the grey economy was the main means of survival for a considerable part of the population, a phenomenon which was therefore tolerated by the state and became a deeply rooted pattern of behaviour.

The establishment of macroeconomic stability in Serbia between 2001 and 2003, together with concrete economic policy measures concerning the unification of the currency market, setting up a new banking system, tax reforms, especially reducing the burden on earnings, and deregulation of working relations reduced the impact of the generators of the grey economy in Serbia. However, widely spread corruption and criminality, that is, ineffective operation of the legal system, still stimulate the grey economy.

In Serbia, the grey economy is still one of the main means of survival of the poorest section of the population<sup>79</sup>, but is also a way to increase profits by avoiding government taxes by those sections of the population who are not at financial risk.

### *Scope and characteristics of the grey economy*

On the basis of data from SLSP, it has been estimated that about a million people in Serbia in 2002 were involved in the grey economy, which represents a little less than one third (30.6%) of those who actively participated in the labour market<sup>80</sup>. Apart from this, 10.8% of the persons that had a main job (either in the regular economy or in the grey economy) had an additional job in the grey economy. These figures certainly indicate that the grey economy in Serbia is still considerable. Examined by type of settlement, the grey economy was considerably less widespread in the cities (38%) than in other areas (62%), and examined by activity, it was most widespread in agriculture (49%), trade (13%), handicrafts, and services (10%). The grey economy was more widespread among those with lower educational qualifications as opposed to the formal sector, in view of the fact that 48% of people in the grey economy had the lowest educational qualifications, while in the formal sector this percentage is less than half that (22%).

The attractiveness of the hidden labour market lies in the fact that average earnings per hour were 28% higher than in the formal labour market, amounting to 83 Dinars or 1.3 USD. Higher earnings per hour in the informal than in the formal labour market, among other things, emanate from tax evasion. Another important characteristic of the grey economy is that it more adequately rewards educational attainment, in view of the fact that average

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<sup>79</sup> Avoiding payment of taxes to the state is not a primary motive, but a consequence of engagement in the grey economy by this poorest portion of the population.

<sup>80</sup> All categories of active population have been covered (except the unemployed).

earnings per hour of those with the highest educational qualifications were more than twice (2.7) as high as the earnings of those with secondary school qualifications, and more than twice as high as the wages of employees with university qualifications in the formal sector<sup>81</sup>.

*Influence of the grey economy on poverty*

The incidence of poverty was higher among those working in the grey economy than among those employed in the formal economy. The poverty risk of those employed in the grey economy (Table 2) was more than a third higher than the average poverty risk of the employed population, and the depth and severity of poverty is greater than among those employed in the formal economy. Such a large share of the grey economy among the poor employed clearly indicates that the grey economy is still the main means of survival of a major portion of the poor population.

**Table 2. - Grey economy and poverty in Serbia in 2002 (in %)**

	% Vulnerable	% of the poor	Relative poverty risk	Structure of those employed	Structure of the poor employed	Poverty depth	Poverty severity
<b>Employed in:</b>							
<b>Regular economy</b>	14.7	7.3	-16.4	69.4	58.0	1.4	0.4
<b>Grey economy</b>	22.7	12.0	37.1	30.6	42.0	2.5	0.8
<b>Total</b>	17.2	8.7	-	100	100	1.7	0.6

**Note:** Employed individuals are defined as persons who, in the reference week, did any job for money or any benefit in kind. The data refer to employees over 15 years of age. The relative poverty risk is calculated as a percentage growth (drop) of the poverty index of the reference group compared to the average poverty index of the employed.

**Source:** SLSP 2002.

The main characteristic of the labour market in Serbia is its segmentation into the formal labour market and the informal, i.e. 'grey' labour market. A relative inertia in the formal labour market, the recent rigid legislation in labour relations, and low wages and relatively high taxes and contributions on wages in the previous period were the main stimulants for the functioning and spread of the informal labour market. A high degree of discrepancy between the supply and demand for labour, a high hidden unemployment rate and the considerable size of the informal labour market, indicate that the formal labour market does not function adequately, i.e., that it does not allocate human resources optimally. Among poor employees, those involved in the grey economy represented 42% in 2002. Such a high share of the grey economy among poor employees clearly indicates that it is still the main means of survival of a major part of the poor population. The interconnections of the formal and informal components of the labour market confuse the real relationships in the market

<sup>81</sup> The earnings of those employed with university qualifications in the formal sector were higher by around 50% than the wages of those with secondary school qualifications.

and make it more difficult for the government to pursue an efficient labour market policy. A high degree of segmentation of the labour market into the formal and informal sectors is of particular importance for the forthcoming reforms and future policy in the labour market.

### ***1.1.2. Goals and Strategic Options for Employment Policy and the Labour Market***

#### **1.1.2.1. Starting Points**

The basis for the reduction of poverty is improved economic effectiveness and economic growth. More rapid and large-scale employment represents an important goal of this strategy because unemployment is one of the main causes of poverty and exclusion in Serbia. Stimulation of employment does not represent an isolated goal of economic policy but a project of society. For its implementation it is important to have a «wide partnership». Employment policy encompasses all the measures that either directly or indirectly influence the scope and the structure of employment and should not be reduced to labour market policy (labour legislation, passive and active measures). It is necessary that measures concentrating on the stimulation of employment be placed in the context of a global economic reform in order to establish the elements of a consistent employment policy, at the same time coordinated with other measures. Any partial approach would be counterproductive and would incur additional costs.

The employment policy is founded on «four strategic pillars»:

- development of entrepreneurship,
- upgrading of the working skills of unemployed labour,
- improvement of the adaptability of enterprises and the mobility of the labour market and the unemployed,
- provision of equal opportunities for employment of both women and men.

Such a policy ought to promote an array of work-related rights (the right to fair and favourable working conditions, protection from all kinds of discrimination, the right to belong to a trade union, safety at work) and improve the position of certain categories of population especially at risk of poverty (women, persons with disabilities, Roma, young people).

#### *The Structure of Existing Unemployment*

Unemployment in Serbia is neither frictional nor cyclical, it is rather transitional and structural. The large-scale long-term unemployment indicates that the major problems lie in economic growth. The fact that in 2002, despite a high unemployment rate, 77,888 vacancies remained unfilled indicates that the above-mentioned structural problem exists in the labour

market. The cause of these positions remaining vacant is partly because suitable people for them are engaged in the grey labour market.

#### *Prevention of large-scale new unemployment («redundancies»)*

Transitional unemployment is a special form of structural unemployment. It is not related to particular regions or branches of the economy, its causes lie in changes in the economic and social system and the process of structural adjustment.

Privatisation, deregulation, and the liberalization of the market, as well as a more consistent implementation of bankruptcy legislation, will increase existing unemployment. Structural adjustments will cause the loss of jobs for a part of the workers (the estimate is from 100 000 to 600 000 people). Those regions where «socialistic giants» were located and where the majority of workers were employed (around 60% of employees in industry are employed in large enterprises) will be particularly affected. It is of the utmost importance that those who lose their jobs in the process should not move into long term unemployment.

#### **1.1.2.2. Institutional Changes in the Labour Market with the Aim of Stimulating an Entrepreneurial Climate**

The establishment of a system of institutions that satisfy the requirements of the market economy and free enterprise also implies changes in the labour market. Any rigidity in this area, in the long run, results in unemployment and a decline in productivity. Labour market policy does not create new jobs, but rather assists in the development of an overall institutional climate, which stimulates new employment. The demand for labour also depends on the institutional characteristics of the labour market. This is usually neglected and it is considered that the only important thing is to stimulate economic growth and that the employment problem will thereby be solved. The situation is far more complex and the institutional policies that govern the labour market are of great importance for new employment. Economic growth is a prerequisite but it is not a sufficient precondition for new employment.

Change of the institutional framework in the area of labour market and labour relations should be concentrated on three goals:

- providing greater market flexibility with regard to wages and employment,
- stimulation of demand by entrepreneurs for labour,
- improving labour productivity..

The first step in establishing new regulation of relationships in the labour market was made by the Labour Law.

*The Labour Law became effective on December 13, 2001. It has considerably simplified the process of employment. The Law governs only the basic employment criteria (age, working ability, it prohibits discrimination on the grounds of gender, nationality, religious affiliation and the like) and states the basic rights and obligations of the contracting parties, while employers have the freedom to establish all other parameters of the contracts of employment. It also provides for different forms of flexible employment (employment of workers to work shorter hours, temporary employment, employment for work at home, work on contract). The dismissal procedure has also been simplified, and the amount of severance pay has been reduced. The minimum wage is agreed between the Government of the Republic of Serbia, representatives of labour unions and representatives of the association of employers. If a consensus cannot be reached, the minimum wage is determined by the government of the Republic of Serbia. It is determined for the full working hours and an average performance for a period of at least six months. Other wages are subject to collective negotiation. Sick leave criteria and penalties for employers who do not observe the regulations have been tightened.*

Despite the existence of formal preconditions for the operation of a more flexible labour market there are no notable changes in practice. The stipulations of the Law are not being applied because transformation of ownership has not yet been completed. The existing management structures in the companies not yet privatised do not provide incentives to change the scope and structure of employment.

An important step towards rounding off the institutional environment in the area of the labour market is represented by the new Law on Employment and Unemployment Insurance. Furthermore, it is planned to proceed to drafting the following: Law on Safety and Health at Work, Law on Trade Union Organisations and Employers' Associations, Law on Amicable Settlement of Collective and Individual Industrial Disputes, Law on Strikes, Law on Employment of Persons with Disabilities. It should be born in mind that these changes do not require additional finances.

### **1.1.2.3. Labour Market Mechanisms**

The key to a more effective labour market lies in the improvement of conditions for the functioning of the mechanisms of work. Measures aimed at improving conditions have two directions: improving the quality of the labour supply and changes in its structure in line with a modern market economy, as well as improved flexibility.

Active measures for the stimulation of employment should be delegated to regional and local levels which will develop their own employment programmes, in keeping, as far as possible, with target groups.

## **Change from passive to active measures**

Unemployment benefits<sup>82</sup> are received by only a small number of persons so that this measure does not fulfil its function as temporary social protection for the unemployed. According to the plan of the Republic Labour Market Bureau for 2003, the share of scheduled expenditures for insurance and servicing of entitlements of the unemployed in overall expenditures amounts to 85% and it should cover 81,000 of the unemployed. Such a distribution of allocated resources limits real possibilities for the use of active support to employment. Passive measures cannot do much to solve the social problems of the unemployed in Serbia, in view of the fact that unemployment is large-scale and long-term. This kind of financial assistance should be directed only to those who are really in the greatest need.

It is necessary to concentrate on active measures that involve the creation of prerequisites and opportunities for the easier employment of those made redundant and unemployed workers in new production programmes. For all active employment measures there are precise legal procedures specified. The Law on Employment specifies that the programme of active employment policy for the Republic is to be adopted by the Government, and that the relevant local self-government authorities can formulate the programmes for territorial autonomy and local selfgovernment. The funds for the financing of these activities are allocated from the budget of the Republic and from the budgets of local communities, as well as from other sources.

## **Raising the Value of Human Resources**

Transition towards a market economy changes the type of skills required. This is why professional training, retraining and additional qualification should run in parallel with privatisation.

Within the labour supply more than a third of the workers do not have professional qualifications, while around 30% have secondary school qualifications. This is a category for which the demand has been drastically reduced. Additionally, among the unemployed those looking for a job for the first time are dominant (69.8%) – the percentage is higher in Central and Southeast Serbia (the region in which poverty is the highest) – as well as those unemployed for extended periods of time who have lost contact with the labour market.

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<sup>82</sup> In accordance with the Law on Employment and Unemployment Benefits the right to compensation will be granted to an unemployed individual in the following circumstances: termination of the need for performance of work, bankruptcy, liquidation and all other cases when the employer ceases to operate, failure to meet projected objectives as well as confirmed inability to perform work, if the spouse has been relocated and if the individual has been working abroad.

Without additional education it is not realistic to expect that these workers can again permanently join the world of labour.

The acceptance of the principle of lifelong education is the only strategy that guarantees flexibility and adjustment of the labour resource to a dynamic environment.

*Refugees and internally displaced persons are in a specific position. They are allowed to register as unemployed, but a problem arises because a large number of these people cannot produce relevant evidence of their educational qualifications. This issue cannot be addressed in isolation from other former Yugoslav republics, but through governmental cooperation with the countries that these people fled from.*

*The problem of poor education is particularly prominent among the Roma. The low educational level of this group considerably impairs their opportunities for inclusion into the world of labour, thus creating a vicious circle of poverty. This circle could be brought to a halt only through education and training in the broadest sense of the words. The fact that this population is most numerous in the regions that are particularly affected with poverty adds weight to the problem.*

It is important for this process to be brought as close to employers and their needs as possible. All programmes of re-training, i.e. training in a wider sense, that are organised without the concrete participation of employers seldom result in new large-scale employment of the workers involved.

### **Upgrading of mediation**

It is necessary to improve the system of counselling and mediation between employers and the unemployed since counselling and mediation are activities that result in positive benefits.

*The Law on Employment and Unemployment Insurance was adopted on 10 July 2003. It aims at creating an institutional environment, which is significantly different from the existing one. The position of all the key stakeholders is radically changed. It plans the setting up of the National Employment Service, as well as the possibility of establishing private agencies. The intention is to encourage competition and consequently raise the quality of services. Private agencies will be concentrated, subject to their profit orientation, on employment of those groups of workers that are easy to employ. The importance of the National Employment Service will still be great, and the groups of workers for whom there is a low demand will quite certainly remain in the domain of the activities of the National Employment Service. Within the National Employment Service there will be a business centre, providing different kinds of assistance in self-employment, as well as a job club in which the unemployed will acquire knowledge, abilities, and skills for their job search. The Law also introduces an innovation: the obligation that the National Employment Service and the person who has been unemployed for an extended period of time (a long-term unemployed person is someone who has been on the unemployment register for over two years), as well as the unemployed who are entitled to pecuniary compensation, conclude an agreement on the conditions, procedures, and measures for finding employment.*

The intention is to bring those who offer and those who search for employment closer together (using employment fairs, the internet, etc.)

#### *Characteristic measures for the stimulation of employment*

In order to maximise their impact, the following measures should be brought in keeping with local circumstances.

**Employment of those made redundant:** The Ministry of Labour and Employment adopted, in 2002, the Social Programme for those made redundant through which measures for their re-employment are proposed.

- As unemployed, a worker may register with the Labour Market Bureau and be granted the same rights as all other unemployed.
- An employee may receive one-off cash compensation, which is not subject to taxation. The compensation amounts to ten average wages or 6,000 Dinars for each year of service.
- The third option is financial compensation accompanied by additional training.

So far about 90% of workers have taken the second option, the purpose of which is to stimulate self-employment. For the implementation of this Programme the Ministry of Labour and Employment has allocated funds for this year amounting to 7.5 billion Dinars (around 125 million USD ).

Although the problem of those made redundant is severe, it will not be dramatic for two reasons

- First: a great number of these workers have additional incomes, which are the result of their involvement in the informal economy, additional work in agriculture or some other activity. Some have even become entrepreneurs.
- Second, most companies employing large numbers of workers will not undergo privatisation and restructuring in 2003 and 2004, thus allowing sufficient time for the development of small and medium enterprises.

**Retraining:** There is no linear relationship between surplus labour and new employment opportunities. Because of this, together with the above-mentioned changes in the skills demanded, the workers who have lost their jobs may not automatically be those who will get a new job.

Privatisation and restructuring will most likely increase the number of least qualified unemployed, lacking the skills required by the new economy. This is why these groups need extensive retraining programmes – in order to be able to switch to those sectors of the economy that are expanding, both as employed and self-employed.

**Subsidizing a portion of the labour costs:** It is also planned to stimulate new employment by subsidizing employers during 24 months for contributions for pension and disability insurance, health insurance, unemployment insurance, when they employ an unemployed individual who has been waiting for employment for an extended period of time. If an employer employs a person who is over 50 years of age, then this subsidy can be obtained

for 36 months. It is not realistic to expect employers to employ a greater number of persons over 50 years of age in a situation when there is a huge number of unemployed who are under 40 years of age (66%). This measure can be applied in situations where targeting is simple, for example, for an especially depressed region or city.

These programmes also involve incentives for the employment of trainees (i.e. young people), as well as persons with disabilities and other groups at risk. In the past year there were 2 000 trainees, of whom half had university qualifications. The trend of employment of trainees has been declining for two reasons: lack of financial resources and the requirement that a person has to be already permanently employed in the phase of intern training. The second reason has significantly reduced the interest of employers.

At the end of 2002 there were 19 302 persons with disabilities on the unemployment register of the Republic of Serbia. The National Employment Service has significantly supported the opening of new job vacancies for persons with disabilities (the Bureau participated in financing 71 investment programmes). The wages of persons with disabilities are subsidized by 80%, and the other at-risk groups by 30%. This covers a small number of the unemployed due to the lack of funds.

*The drafting of the Law on Employment of the persons with disabilities is under way, and its passage is expected by the end of 2003. This Law focuses on the creation of a legal framework that would enable persons with disabilities to show their abilities and express their creative potentials, and acquire economic independence through active participation in the world of work. The goal to be attained is inclusion of persons with disabilities in society, rather than their exclusion. This law envisages the introduction of employment quotas for persons with disabilities. It will also provide for their special care, occupational rehabilitation and professional training (the Fund for Professional Training and Employment of persons with disabilities is to be set up), and safety at work.*

**Self-employment:** Self-employment can be stimulated by paying one-off cash unemployment compensation, subsidies, and additional education and training, assistance by business centres. There are also special incentives for self-employment of those made redundant. If ten or more persons who have been made redundant pool together, and set up a business partnership, a cooperative or a similar enterprise, they can obtain non-repayable funds amounting to 150 000 Dinars. The amount of severance payment varies from one enterprise to another, and not even very high severance payments (several dozens of thousands of Euros) have contributed significantly to the establishment of new enterprises, since they have mainly been spent for different forms of consumption. Therefore, self-employment should be stimulated by other measures.

**Public works:** The goal is to employ those categories of the unemployed who are most difficult to employ, persons in social need, and the unemployed over 50 years of age. Public works should be, according to the Law on Employment, organized for carrying out works of general interest (for example, in the area of social, humanitarian, cultural, and other activities). The funds for this purpose would be provided from the budget of the Republic, from the territorial budgets and from local selfgovernment, as well as from other sources of financing. Such programmes can be applied on a smaller scale for specially targeted groups

(with clearly emphasised social goals) with the necessary addition of different forms of education.

#### **1.1.2.4. The Labour Market – stakeholders and their roles**

Successful labour market reforms demand a wide partnership since the result of the above-mentioned measures will mostly depend on the overall economic environment along with the activities of all relevant participants.

Who are the main stakeholders in the process and what is expected from them?

**The Government and relevant ministries** should enable the establishment of an institutional framework that by its characteristics corresponds to the contemporary market economy and stimulates investments. The first step is to adopt key laws (among other things, to complete the initiated amendments in the labour legislation). The second part of the Government's jurisdiction is global economic policy which should encourage investment and economic growth. The third step consists of the above measures to actively stimulate employment. In the processes of institutional changes in the labour market the key role belongs to the Ministry of Labour and Employment. This Ministry will also implement the National Employment Strategy, as well as the Employment Action Plan. Apart from changes in legislation, this Ministry should also strengthen labour inspection.

*The Ministry of Labour and Employment anticipates the adoption of the following laws: the Law on Safety and Health at Work, the Law on Trade Union Organisations and Employers' Associations, the Law on Amicable Settlement of Collective and Individual Industrial Disputes, the Law on Strikes, the Law on Employment of Persons With Disabilities.*

The Ministry of Science, Technology and Development, the Ministry of Education and Sport, as well as all other stakeholders in the educational network, should actively participate in the process of the education of the unemployed for the purpose of achieving stronger and more functional ties between the requirements of the labour market and the educational system.

This process calls for a social dialogue. The establishment of socio-economic councils at national, regional and local levels will provide the institutional basis for a dialogue. In some municipalities socio-economic councils, planned to coordinate the activities of key local actors, are already being formed. This will also enable inter-sectoral cooperation. Apart from consultative activities and harmonization of measures, these councils will also perform evaluations of outcomes.

**Mediation services:** In the process of improving mediation, the key role lies with the Republic Labour Market Bureau and private agencies. It is necessary to undertake an organizational restructuring of the Bureau, its modernization and the upgrading of the quality of the work of its employees. Due to local specific problems of unemployment, the local employment services must be given greater freedom and authority to work out their own programmes to suit the situation in the field.

Familiarization with foreign experience and continuous training Bureau employees would professionally strengthen this institution and raise the quality of its operations. The business premises available to the Bureau are insufficient and inadequate. The number of employees should be increased (one counsellor works with some 2,500 unemployed persons), and the existing information system modernized.

**Local selfgovernment** is responsible for promoting local initiatives, the improvement of the entrepreneurial environment and the provision of public services. This also implies the need to establish strategies for regional and municipal development. Without these, efforts and resources will be dissipated, and the effects will not be concentrated on key aspects and on the most important areas.

*It is also necessary to create the relevant local infrastructure for the implementation of these measures, in order to be able to implement the programmes based on local conditions and requirements. For their implementation local self-government institutions should be put in charge, which also must be followed by a certain financial autonomy.*

For the undeveloped parts of the country (where the infrastructure as a whole is unsatisfactory) it is necessary to instigate concrete initiatives for the revival of production. This may also include giving special concessions to foreign investors with the aim of attracting them (the above mentioned «soft instruments»). It is necessary to create integrated models of professional adult education that link the labour market, the network of institutions for adult education, local authorities and the local economy. The social partnership that is a prerequisite of these activities on the local level involves the participation of the local labour market, enterprises, professional associations, trade unions, entrepreneurs and their associations, and institutions of informal education.

**The unemployed:** The unemployed are primarily responsible for their own employment and should assume a more active role concerning training, mediation and other relevant aspects. So far, some of the unemployed have demonstrated an extraordinary lack of action. According to the results of the Survey on the Living Standard of the Population, 45% of the respondents had not even tried to get a job, while 23% are not trying to get a job because they do not want to work (there are no major differences between the genders). The Law on Employment sets forth stricter regulations and the introduction of a measure whereby the unemployed who reject any adequate employment or participation in a programme of active employment measures offered to them are deleted from the records. Such a measure is justified. This is an attempt to make a distinction between the unemployed who are really looking for employment and others who are not. Thus, in a year, the picture of unemployment will be much more realistic.

**Employers and trade unions:** Employers and their associations should actively participate in these processes in different ways (particularly through cooperation in the process of training, as well as by informing the labour market of their actual needs). It is essential that parties taking part in collective negotiations should reach a consensus concerning new employment. The consensus ought to be reached and maintained both at the regional and at the local level. It is especially important to avoid a situation in which a union and an

employer agree on pay rise, shifting the problem of new employment to the state. It is important to create favourable circumstances for new employment through a consensus.

**Non-governmental organisations:** Non-governmental organisations are an important partner in the processes at all levels and especially at the local level. They are an agent which can provide considerable assistance in the inclusion of unemployed individuals who have not been registered with employment agencies into programmes and activities intended for them. On the other hand, non-governmental organisations will also play an important role in the review of the effects of the implementation of certain measures, especially at the local level.

#### *Limitations and necessary adjustments*

There are three key limitations to the successful implementation of the above measures.

The first is related to the overall economic environment. Without a major inflow of foreign investment it will not be possible to increase economic growth to any major extent.

The second limitation is the high unemployment rate. The process of overcoming this limitation cannot be the result of isolated efforts but of a global strategy of economic development. Active measures for stimulating employment are less efficient in the initial periods of transition, because unemployment is not predominantly the consequence of unsatisfactory labour supply and its structure, but of a very low demand for labour. On the other hand, the high unemployment rate makes more difficult the stimulation of employment of particularly vulnerable groups of the unemployed.

The third limitation is the financial constraints. The funds at the disposal of the Republic Labour Market Bureau are limited. The active programmes and measures have not been able to influence the change of the unfavourable situation in the labour market to any significant extent, because of the lack of funds.

*The funds allocated for the labour market ranged from 0.4% to 0.6% of GDP. The budget for 2003 amounts to around USD 199 million, whereby the planned share of expenditures for insurance and servicing of the entitlements of the unemployed in the overall expenditures amounts to 85.0% and the share of the expenditures for financing the active employment policy amounts to 8.7%. Certain problems have arisen regarding this disbursement. It has been delayed for five months now, while between 3.5 and 4 billion dinars are needed to cover the outstanding debts (in January 2003 alone, the debt amounted to 786,204,532 dinars).*

Not much can be done with the modest funds available and some measures that have already been introduced are at risk of being discontinued). It should also be noted that a part of these expenses is financed from the Transition Fund (for example, a one-off severance pay to redundant workers).

The costs of the existing measures cannot be financed by the funds at the disposal of the Labour Market Bureau, and it is necessary to include funds from government and local budgets (for the local programmes), as well as funds from foreign donors. The major portion of these funds should be allocated to the training of the unemployed and those made redundant (in the past year such programmes covered only 11,300 workers.), the

implementation of special programmes for persons with disabilities and those who are hard to employ, employment subsidies, programmes for active job search, stimulation of entrepreneurship, and other employment measures and programmes.